

# **The Nonprofit Theory Revisited**

*The Advantages and Challenges*

*for the Third Sector*

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Master Thesis for the

Economic Theory and Econometrics Degree

February 12

Department of Economics

University of Oslo

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<http://www.duo.uio.no>

Press: University Print Centre at the University of Oslo

# Illustrating Quotes

*My view is that nonprofits organizations are largely a way of solving informational problems. Managers of nonprofit organizations lack the incentive of profit that might otherwise tempt them to misrepresent their products or services (Weisbrod 1988, page vii).*

*In spite of the limitation imposed upon them, nonprofits may succeed in distributing some of their net earnings through inflated salaries, various perquisites granted to employees and other forms of excess payments (Hansmann 1980, page 844).*

# Abstract

In my master thesis in economics, I draw attention to nonprofits with core focus on the ones that are operating in the business sector. I aim to investigate how nonprofits function, and how they differ from other organizations. The main question I ask is: ‘What are the pros and cons of nonprofits, and in what ways do they differ from other organizations?’ Furthermore, I raise three probed further: ‘What are the roles of the nonprofit sector, and why does it play these roles?’ ‘What do nonprofits do when they are not maximizing profit, and which other aims are relevant?’ ‘How does the interior incentive structure function when the organization has other aims than profits, and there are no owners to discipline the management?’

After pointing out my questions, I sketch the organizational map for forprofit, public and nonprofit organizations, before I give a brief introduction to the nonprofit landscape. Thereafter, I investigate the three most common demand approaches to nonprofits; namely the public good approach, the trust approach and the stakeholder approach. In relation to the public good approach, I show how green worker theory could be integrated to the formal model framework. I also suggest an integration of green consumer theory in the trust approach. Further on, I examine three supply approaches; the entrepreneurship approach, the voluntarily failure approach and the organizational behavioral approach.

After reviewing the prevailing theories, I continue by discussing the potential problems of moral hazard and rent-seeking, before I display how these can be overcome both with and without behavioral factors, inter alia by my own game of internal control. Towards the end of the thesis, I turn to the financial side of the nonprofits, comprising sources of financing and potential financial rigidity. I discuss the lack of financial flexibility and how the problem can be countered, which is one of the most neglected realms in the prevailing nonprofit literature.

I conclude that nonprofits could be the best response to governing and market failures, both on the demand side and the supply side. Moreover, nonprofits seem to achieve comparative advantages contra the forprofits and the public enterprises under certain circumstances, by their combination of inability to distribute profits, political autonomy and social aims; and for some nonprofit organizational designs; their leeway for stakeholder control. These features may inter alia enable nonprofits to attract green workers, provide public goods that cut across political priorities and achieve more trustworthiness in the provision of unverifiable goods.

# Preface

In 2008, I got a summer internship at the financial department in the Norwegian administration of the Norwegian business foundation, Det Norske Veritas (DNV). DNV is engaged in various business fields within various energy and maritime sectors. After starting in my new job, I soon got fascinated by what I perceived as a very idealistic and well-functioning organization, albeit the lack of owners to discipline the management. Admittedly, I observed certain perquisites like an extra week holiday for the employees and support to the employees' environmental initiatives. Yet, I chiefly perceived my colleagues as hard-working with an idealistic affiliation towards the organizational objectives. Allegedly, DNV was not even a wage leader. I even heard stories about employees returning from Aker Solution and Statoil for lower wages, because they felt a stronger belonging to DNV.

I continued my engagement at DNV as a financial accountant, mainly during holidays, up the spring of 2010. Gradually, I became more aware of other nonprofits in the society and started to wonder which role they played in the economy. During my studies, I was puzzled by the limitedness of literature on various organizational forms and the absence of behavioral factors within the theory of the firm. It was this absence of literature and the complex characteristics of nonprofits that made me choose nonprofits as the topic of my master thesis. As an ambitious person, both in positive and the negative meaning of the word, I tried to embrace most aspects of the literature, although focusing mainly on nonprofits in the business sector.

In context of my thesis, I would like to direct an especially great thank to my supervisor, professor Kjell Arne Brekke, for useful guidance, productive feedback, fruitful discussions – and moreover – a good collaboration during the writing of my thesis. What is more, I would like to thank my good friends Craig Peter Taunton, Endre Kildal Iversen, Marianne Fiedler Rørvik and Tord Kopland Eid for solid proof-reading and encouraging support, all contributing both on academic and linguistic matters. In addition, I would like to thank my second cousin Ragnhild Holmen Waldahl for valuable inputs. Waldahl is a researcher at Nordland Research Institute and is specialized within the interaction of the civil society and the public sector. All inaccuracies and errors in this thesis are mine and mine alone.

Rasmus Bøgh Holmen

February 2012

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# 1 Introduction

When economists talk about firms, they mostly refer to forprofits. Occasionally, some friends of mine with economic background mention a nonprofit, but they are often not aware of the firm's legal status. If organizational forms are discussed, these are primarily public or forprofit. In microeconomic text books, the focus lies mainly on the forprofit sector and the household sector, and their interaction with the public sector. In advanced textbooks, many extensions like more complex cost and markets conditions are made, but organizational forms are seldom highlighted (see for instance Cowell 2006, Mas-Colell et al. 1995 or Varian 1992). Both the variety of organizational forms and the third sector are neglected, if not as unimportant, so at least as less relevant for the core study of microeconomics. When I asked my professors about the so called 'third sector', few of them had extensive knowledge on the topic. 'An interesting topic, but I do not know much about it', was the typical answer. Some of them knew people, who had more knowledge about the sector, but the 'real expert' on nonprofits among Norwegian economists seemed to be nonexistent, as far as I was concerned.

Moreover, the nonprofit sector has emerged in the crossroads of the forprofit sector and the public sector. There is no consensus on which definition to use among different authors. In my thesis, I generally choose to apply a broader definition, emphasizing the whole third sector; namely every organization outside the public sector that does not have profit maximization as the sole primer aim, excluding poorly governed forprofits. By this definition, I neither exclude business foundations, cooperatives, mutuals nor non-government organizations. An alternative definition, implemented in legislations in many Western countries, highlights the inability to distribute profit as the main feature of nonprofits. Compared to public enterprises, nonprofits are less bounded by political concerns, but more financial rigid. Following the principle of consumer sovereignty, implying perfectly competitive markets and full information, one should expect firms that do not maximize their profit to go bankrupt. In fact, in a sterilized world characterized by consumer sovereignty, it becomes difficult to explain why nonprofits would be established in the first place. Yet, the nonprofit sector was growing worldwide for decades up to the global financial crisis in 2008.

The Norwegian business life is populated by a wide range of actors from the third sector. Let us imagine a guy that studies at *BI Norwegian Business School* in Oslo. After a long and

intensive day of studies, he goes to the grocery store, *Coop Norge*, and buys some food from the dairy producer, *Kavli*. When he walks out to his car, he soon discovers that something is wrong with the right flash light and calls his insurance company, *Gjensidige Forskring*. A minute later, his girlfriend phones him from her employer, *Det Norske Vertias*, asking him if he could meet her there. Having forgotten his computer at his part-time employer, *SINTEF*, the guy drives and picks it up; before he rushes on to meet his girlfriend. When he arrives, she suggests that they drop by *Hennie Onstad Art Center*, which lies next to her work. After a guided tour through the center's beautiful exhibition, they visit the girlfriend's grandmother at *Diakonhjemmet Hospital*. In the end of the day, the guy kisses his girlfriend good night and looks back at a seemingly ordinary day. At first glance, the story might seem boring. Nevertheless, the story becomes fascinating and remarkable once one realizes that everything about our guy's day was about his girlfriend and nonprofits; an common economic phenomenon which one could have limited knowledge about, even after achieving a doctor degree in economics.

In my master thesis, I draw attention to the third sector with core focus on nonprofits operating in the business life. The main question of the thesis is: 'What are the pros and cons of nonprofits, and in what ways do they differ from other organizations?' Nonprofits coexist with forprofits and public firms in some industries, whereas it actually drives its institutional counterparts out in others. Drawing attention towards the American knowledge sector, a majority of the most acknowledged universities are neither forprofit nor public – they are nonprofit! My first probe further is: 'What are the roles of the nonprofit sector, and why does it play these roles?' Our understanding of the economy is largely based on models, where firms are assumed to maximize profits. Yet, nonprofits with other objectives than just profits per definition, and thereby weaker private incentives, have in many occasions proved to be economic successful. By this token, I ask: 'What do nonprofits do when they are not maximizing profit, and which other aims are relevant?'

Furthermore, nonprofits have no owners to control the management. According to traditional principal-agent models, one should expect moral hazard. Conversely, psychology-inspired literature highlights idealism and intrinsic motivation as driving behavioral forces in organizations, when the workers identify themselves with the organizational objectives. My last question is: 'How does the interior incentive structure function when the organization has other aims than profits, and there are no owners to discipline management?' On the one hand,

The Norwegian Foundation Authority had above 800 cases for about 8,500 foundation regarding irregularities in 2010 (Mauren 2010). On other hand, Bacchiega and Borzaga (2003) refer to research, which implies well-functioning incentives structures and lower salaries in nonprofits.

In compliance with the complexness of the nonprofit sector and the questions raised, I will go through a wide range of issues and topics. I start out by this introduction in chapter 1, by arguing that the study of nonprofits have been too much neglected and deserve to be drawn into the spot light. Next, I will sketch the organizational map for forprofit, public and nonprofit organizations in chapter 2, because I believe that a reflective and transparent organizational outline could provide a broader understanding of the roles of nonprofits and the variety within the third sector. In chapter 3, I give a brief overview over the nonprofit landscape both in Norway and worldwide and provide predictions on how it is likely to develop. I do to some extent apply social origin approach, when discussing the contemporary nonprofit sector.

The theoretical approaches to nonprofits are often divided into demand approaches and supply approaches, depending on which side of the market the core focus is on. I review three demand approaches in chapter 4, namely the public good approach, the trust approach and the stakeholder approach. First, I go through the public good approach, originally formulated by Burton Weisbrod in 1975. The approach highlights how nonprofits can provide economically beneficial public and quasi-public goods, which both the private and public sector fail to provide. When reviewing the formal modeling, I show how green worker theory could be integrated to the formal framework. Thereafter, I turn to the trust approach, originally formulated by Henry Hansmann in 1980. The approach sheds light on how nonprofits can appear more trustworthy in the provision of unverifiable services than forprofits, due to their lack of profit incentives. I propose a possible integration of green consumer theory to the trust approach. I then turn to the stakeholder approach, developed by Ben-Ner, Gui and van Hoomissen in the 1990s, where various stakeholders are engaged in the nonprofit organizations.

Furthermore, I review the supply approaches to nonprofits in chapter 5. I start out with the entrepreneurship approach, developed by Young in the 1980s, to explore what I call the paradox of nonprofit entrepreneurship. Next, I go through the voluntary failure approach,

originally formulated by Salamon in the 1990s, to discuss the dynamics between the nonprofit sector and the public sector. Thereafter, I highlight the organizational behavior approach, which was developed by Bielefeld and Galaskiewicz in the 1990s, and brings in insights from evolutionary economics.

In chapter 6, I highlight the interior structures of nonprofits. The analysis of this chapter is largely coinciding with what sometimes is referred to as the property right approach to nonprofits. More concretely, I analyze what will happen in absence of a manager and under alternative conducts to seeking profits, emphasizing both behavioral and non-behavioral factors. I advocate integration of green worker theory in the study of nonprofits and show through my own Game of Internal Control how non-behavioral control structures may or may not work. Towards the end of my thesis, I turn to the financial side of the nonprofits in chapter 7, comprising sources of financing and potential financial rigidity. I throw light over the income sources of nonprofits; namely public and private donations, fees and sales; and discuss these in the context of crowding in and crowding out effects. Towards the end, I highlight the lack of financial flexibility for nonprofits, and how the resultant issues can be overcome, which is one of the most neglected realms in the prevailing economic literature about the nonprofit sector. Finally, I summarize my findings and draw my conclusions in chapter 8.

## 2 Categorization of Organizations in the Business Sector

The Nonprofit Sector has emerged in the border line between the forprofit sector and the public sector. Although the third sector has played a role in the economy since ancient times, the theory on the sector did not occur before the 1970s and 1980s (Ware 1989). In addition to these three sectors, households constitute a fourth sector. Endowed with time and assets, the households are commonly considered as utility maximizing consumers, which also are capital owners, workers and so on. In formal modeling, households are usually assumed to have either full or bounded rationality. I choose not to pursue the treatment of the household sector any further here. Krashinsky (1986) makes a point regarding the principle of consumer sovereignty, which states that under perfectly competitive markets and full information, the consumers will determine which products that are produced. This conjecture leaves no room for survival of firms that do not act efficient in accordance with the preferences of egoistic and rational consumers, unless they receive some external financing. In such framework, public goods may be publicly financed, but there would be no space for nonprofits, where various stakeholders could affect the organization's adaption. Perhaps not that surprisingly, nonprofits often spring up due to lack of competitive markets and full information.

Analogously, Weisbrod (1975) highlights how governments fail to provide economic desirable goods that are not inconsistent with the prevailing political preferences. Since all accessible organizational arrangements are less than perfect, the issue about choosing institutional form will hence be a 'second-best'-matter of coming closest to the weighted needs of the various stakeholders (Krashinsky 1986). Moreover, the theory on the nonprofit sector largely suggests that a mixture of market failures and governance failures provide a rationale for the sector. When trying to understand nonprofits properly, I believe it would be wise to start by looking at its counterparts. Hence, I begin this chapter by drawing the organizational map for forprofit and public organization in subchapter 2.1 and 2.2, respectively. Thereafter, I discuss both theoretical and legal based classifications of nonprofits in subchapter 2.3, before I turn to the nonprofit landscape and the theories about nonprofits in the chapters to come. I would like to remind the reader that I use 'nonprofit' as a synonym for a 'third sector firm', although some authors refer to 'nonprofits' as one of several subclasses.

## 2.1 Categorization of Forprofit Organizations

In order to achieve a broader understanding of nonprofit organizations, it could be useful to first take a look at the business form that in many circumstances are considered as their counterparts – namely the forprofit organizations. When economists refer to a firm without any further specification, they usually mean a forprofit. As for nonprofits, there is surprisingly little literature on the classification of forprofits. Standard advanced microeconomics books like Cowell's *Microeconomics – Principles and Analysis* (2006), Mas-Colell, Whinston and Green's *Microeconomic Theory* (1995) and Varian's *Microeconomic Analysis* (1992) extend the modeling of the firm in many ways, but they do not emphasize how different organizational forms could affect forprofit behavior. I will now start out by providing some basic insights in section 2.1.1, before I go through the three kinds of forprofit organizations in section 2.2.2.

### 2.1.1 Basics about the Forprofit

Forprofit organizations are characterized by their search for profit. They typically provide goods or services to some consumers in order to earn the highest possible profit at a chosen risk for their owners, who could be both public and private. Different choices of forprofit organizational form have different implications for concentration of control, auditory and tax obligations, liability and credit worthiness, as well as financial flexibility. Hamilton (2004) highlights how liability and tax consideration play decisive roles in the choice of forprofit organizational form. In line with Bielefeld and Galaskiewicz' (2003) macro-organizational theory in section 5.3.4, I will argue that different kinds of needs and requirements from the surroundings call for different kinds of institutional arrangements. In Norway, forprofit employees achieve some control rights, when the staff is large (see for instance The Norwegian Minister of Justice and the Police 2007, 2011a and 2011b).

### 2.1.2 Types of Forprofit Organizations

Forprofits can be divided into three main types of entities; sole proprietorship, private partnerships and private corporations. In Norway, they are represented by a variety of legal forms with different characteristics. Besides, cooperatives, mutuals and business foundations lie in the border line in between the forprofit sector and the nonprofit sector. These are treated



in section 2.3.4. Similarly, state companies could be considered as a mixture of forprofits and public enterprises. These are treated in section 2.2.2.

## **Sole Proprietorships**

The simplest kind of forprofit organization is the sole proprietorship, which is an enterprise owned and ran by a single individual. In Norway, these sorts of entities are known as *enkelpersonsforetak*.<sup>1</sup> An *enkelpersonsforetak* may employ others (Altinn 2011a). A sole proprietorship involves unlimited liability up to personal bankruptcy, which of course implies a certain risk for the owner. On the other hand, the feature generally makes the owner more credible as a solvent borrower, and is thus likely to provide her with better borrowing conditions *ceteris paribus* than an organizational form with limited liability (Berkowitz and White 2004). This is of course given that the owner has a decent and lucid personal economy.

More generally, the owner's business obligations are inseparable from her personal obligations; a property that also has consequences for tax payments. This implies a particularly close interconnection between sole proprietorships and parts of the household sector. Furthermore, faced auditing and legal requirements from the government are often less extensive, and thereby less expensive and bureaucracy demanding, than it is for corporations. Lastly, sole proprietorships could experience troubles in raising capital, noting that other people than the owners are unlikely to deposit money to the firm. Compared to the capital restraints faced by foundations (to be discussed in subchapter 7.2), the sole proprietorship therefore faces challenges regarding expansion too. Austerity is obviously not a problem though, since the owner without costs could give herself dividends.

## **Private Partnerships**

A natural extension from a sole proprietorship is the private partnerships; add one or more owners to the first, and you get the latter. The owners do not, however, need to be private persons; they could also be a legal unit (e.g. a stock company or a foundation). Unlimited personal liability for the owners is nevertheless no requirement for being categorized as a private partnership. It only represents one out of three subclasses known as a 'general

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<sup>1</sup> Freely translated: Single-person's business

partnership'. The second subclass is 'limited liability partnership', where all the owners have limited liability. At last, we have the intermediate case, 'limited partnership', where at least one of the owners has limited liability, and at least one of the owners has unlimited liability (Sheffrin and Sullivan 2003). Like sole proprietorships, private partnerships are object to financial rigidity challenges, although these problems are somewhat more relaxed, since additional parties are involved. Besides, different liability arrangements will obviously affect the firm's borrowing conditions; at least in absence of personal sureties.

In Norway, private partnerships are represented by three different legal organizational forms. The one that corresponds to the unlimited personal liability case is called *ansvarlig selskap med udelt deltakeransvar (ANS)*.<sup>2</sup> Conversely, general partnerships are represented in Norway by *kommandittselskap (KS)*<sup>3</sup>, where the owners are grouped into the ones with unlimited liability (the *komplementar*), and the ones who hold unlimited liability (the *kommandittist*) (Knudsen 2011a). The last legal Norwegian type of private partnership is *ansvarlig selskap med delt eierselskap (DA)*<sup>4</sup>. This type covers the border instance between general partnerships and limited partnerships, where each of the participants can be held responsible up to a given predetermined percentage of the firm's debt, which is align with their owner share (Altinn 2011b). There are no organizational forms that correspond to private limited liability partnerships in Norway.

## Private Corporations

The last category of forprofit companies are corporations. These are by some referred to as 'forprofit corporations', because 'nonprofit corporations' occasionally are used for nonprofits in the business life, organized as stock companies.<sup>5</sup> A corporation is owned by one or several investors through transferable shares and constitutes a separate legal personality. The operation is delegated to a management appointed by the owners through a board of directors. The owners have limited liability in case of bankruptcy, but their claims will also be the last to be met. Corporations could be divided into public (listed) and close (unlisted) corporations.

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<sup>2</sup> Freely translated: Responsible company with inseparable participation obligations

<sup>3</sup> Freely translated: Commended company

<sup>4</sup> Freely translated: Responsible company with shared participation obligations

<sup>5</sup> In addition, one of public organizational forms is named 'public corporations' confer section 2.2.2.

Publicity traded corporations are chiefly large, and their shares can easily be traded through a stock exchange, implying large financial flexibility. Conversely, close corporations are typically small, and there are none conventional market shares of close corporations, resulting in financial rigidity. Yet, the publicity traded corporations normally face stricter auditory requirements from public authorities than other forprofits (Hansmann and Kraakman 2004).

In Norway, public and close corporations are represented by *aksjeselskap (AS)*<sup>6</sup> and *allmenn aksjeselskap (ASA)*,<sup>7</sup> respectively. In order to prevent fraud, an aksjeselskap's initial stock of capital must be at least NOK 30,000. The owners of smaller aksjeselskaps must often stand as guarantors for the company's debt, and the access to pay out dividends is limited (Altinn 2012a). An allmenn aksjeselskap, on the other hand, must have an initial stock capital of at least one million Norwegian kroners, and also faces limitation in dividends to their owners. These companies are obligated to have an operative manager and a board of at least three persons (Altinn 2012b). Furthermore, as a member of European Economic Area (EEA), Norway also has transnational stock companies (Knudsen 2011b). In addition, foreign companies' Norwegian divisions are often represented by *Norskregistrert utenlandsk foretak (NUF)*<sup>8</sup> (Altinn 2011c), which usually are organized as stock companies (Zangenberg 2008).

## 2.2 Categorization of Public Organizations

We will now consider another cousin of the nonprofit organization, namely the public enterprise. I start out by discussing some basics about organizations in the public sector in section 2.2.1, before I turn to categorization of public organizations in section 2.2.2.

### 2.2.1 Basics about the Public Organizations in the Business Sector

From an economist point of view, perhaps the most crucial difference between forprofit and nonprofit organizations is that the latter have other objectives than maximizing profit. The same distinction could be drawn between forprofit and public organizations. Yet, in contrast to nonprofits, public firms are legally dependent on the government. Moreover, public firms

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<sup>6</sup> Freely translated: Stock company

<sup>7</sup> Freely translated: Public stock company

<sup>8</sup> Freely translated: Norwegian registered foreign company

are bound by the prevailing public opinion, and their provision of goods is normally more political sensitive than nonprofits' provision of goods. Besides, the financial maneuverability is obviously larger for the public sector. When analyzing public enterprises by normative economic theory, they typically seek to maximize social welfare, presuming some normative judgments about what is ought to be an economic fair allocation. Other normative analyses could involve maximization of particular managerial or political aims. In contrary, the positive theory concerns description and explanation of public organizations' actual characteristics and positive objectives, without involving normative judgments (Bös 1986).

In the context of governance failures and market failures, public ownership (i.e. nationalization) is preferable to private ownership (i.e. privatization), if it involves a more effective utilization of resources. For naturally monopolies for instance, this implies that price is set equal to marginal cost (ibid.). If the financing of the deficits involve distortions, an intermediate solution between the social welfare-maximizing and the monopoly adaption is likely to be optimal in the second best solution. Common examples of goods in these kinds of markets are public utilities like energy, communication, transportations and other goods that require an extensive network to be properly supplied (ibid.).

Public organizations and institutions could also play a major role in provision of public goods, i.e. goods that are non-excludable and non-rivalry. In order to ensure compliance between marginal costs and total marginal willingness to pay, government interference is needed, possibly through public ownership (Hindriks and Myles 2006). Legal systems and military services are examples of public goods provided in nearly every country. Furthermore, the rationale behind public ownership could be externalities. More concretely, there could be benefits for the society as a whole of having arrangements for productivity stimulation and social insurance. Important instances in this regard are education systems and health systems.

Public ownership could be justified by other market failures as well (e.g. exploitation of market power, incomplete markets, information asymmetry, lack of quality and macroeconomic stability) (Bös 1986). Moreover, we observe public ownership in most sorts of enterprises in the Western World, especially in Europe, but in the Anglo-Saxon outskirts too (Anheier and Salamon 1996). Still, the public presence appear to be greater in some sectors of macroeconomic importance, including the banking sector and the ones involved in provision of basic goods, like energy and metals. Where the forprofit organizations are

restrained by a non-negative profit constraint and conceivably some other market constraints, public enterprises often face different restrictions. Public enterprises of course have to deal with the markets as well. Nevertheless, it may well be that they are obliged by other means, such as ensuring a first- or second-best solution, even though it implies running with deficit. What is more, specifically requirements to operations and budget constraints will be of somewhat less importance in these entities' adaption.

Besides, political stakes have to be made. For instance, rigidity in terms of adjustment of the employed labor is usually more common within public organizations (ibid.). Another perspective, than the organization's objective and outer feature, focuses on the firms' inner body. It seems obvious that different political interests, lobbyism, moral hazard, power struggles and rent-seeking, as well as idealism and philanthropy, may play vital roles in the public decision-making. Diverse and weak interests could imply management failures, similarly to the ones faced by nonprofits. Theorists within economics of a firm thus often recognize the public sector as a weak owner. Conversely, closeness to political processes could be an advantage, and public ownership might be less distortive than tax collection.

Last, but not least, the governmental control over a public firm may work directly through both operative and strategic commercial decision-making. Furthermore, government authorities could ex ante influence their business strategy indirectly, by appointing a board or a management. Finally, the government could affect the behavior of the firm being discussed by either financial and managerial auditing, or criticism and instructions. The internal contractual relations within and between the government and the public enterprise ought to be complex. Nevertheless, due to convenience and often illuminating approximation, public economists often focus mainly on two parties – the government and the board (ibid.).<sup>9</sup>

### **2.2.2 Types of Public Organizations in the Business Sector**

There are various ways to classify the public organizations in the business sector. I choose to apply Böz's (1986) categorization, since it in my opinion is rather lucid and covers the main points. Böz distinguishes between three types of public entities; departmental agencies, public corporations and state companies. The boundaries between the forprofit sector, the nonprofit

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<sup>9</sup> In the case of departmental agencies, the management will typically play the board's part when modeling, seeing that these public organizations have no board.

and the public sector are not always clear. State companies are organized as private entities and often have private co-owners. For that reason, these could be viewed as organizations in the border line between the forprofit sector and the public sector. In addition to Böz' three classes of public entities, I believe it is constructive to consider a fourth class, namely public foundations. Similarly to state companies, public foundations lie in the border land between two sectors, but in this case, the concerned sectors are the public sector and the nonprofit sector. Public foundations are legally independent of the government; yet they are somewhat economically dependent, as their activities are based on public grants. Although keeping in mind this fourth class, I find it more appropriate to include it in the treatment of different foundations (confer section 2.3.4). For now, I will thus focus on the three other types.

## **Departmental Agencies**

*Departmental agencies* are public institutions without a separate legal personality. These are usually recognized as an extensive part of some government level, which provide guidelines and instructions for them. Furthermore, the departmental agencies balances and results are generally incorporated into the public's running accounts. Still, they do to some extent hold separate control over their field of expertise and are often partly detached from the strictness of requirements for public accountability. Departmental agencies have an operative management, but no board of directors (Bös 1986). In Norway, an institution of this kind is known as an *etat*. The etats are subordinate organizations to municipal, county- or state level of the government. The Norwegian etats include directorates and supervisions, as well as a diverse group of other institutions that provide public administration and services (Kunnskapsforlagets Papirleksikon 2009a).

## **Public Corporations**

*Public corporations* represent a sort of public institutions with separate legal personality. Each public corporation's objective and degree of control are usually determined by some sort of decree or law. The combination of the nature of its aim and the legal independency makes the public corporation to the closest relative for the private nonprofit organization within the public family, apart from the public foundation. Rather than financing their operations through issues of shares or stocks, public loans and grants constitute the sources of finance. Public corporations have both an operative management and a board of directors (Bös 1986).

There exists a handful of public corporations in Norway, which are acknowledged as different sorts of legal entities. A main classification can be made based on the public owner's level of government; that is *statsforetak* (*SF*)<sup>10</sup> at the state level, *fylkeskommunalt foretak* (*FKF*)<sup>11</sup> at the county level and *kommunalt foretak* (*KF*)<sup>12</sup> at municipality level – and finally – *interkommunalt selskap* (*IKS*)<sup>13</sup>, which is a public partnership held by more than one municipality or county. Besides, the Norwegian legal entities include two types of public corporations within the health sector. The first, *regional helseforetak* (*RHF*)<sup>14</sup>, belongs to one out of four health regions in Norway, while the later, *helseforetak* (*HF*)<sup>15</sup>, forms a group of outlets, controlled and owned by the first type (SSB 2005).

## State Companies

Also *state companies* make up a kind of public institutions with separate legal personalities. In contrary to public corporations, however, state companies are organized under ordinary company law. The fact that they are called state companies simply refers to the virtue of their ownership, seeing as its assets are held either partly or wholly by government actors (Bös 1986). In Norway, *statsaksjeselskap*<sup>16</sup> constitutes the common form for state companies, where the public sector owns all shares (Kunnskapsforlagets Papirleksikon 2009b). The public sector could also be a co-owner in stock companies (confer section 2.1.2). As indicated in this section's introduction, these companies possess many of the characteristics of forprofits. Nonetheless, in spite of similarly legal status, state companies could be managed differently than private companies, remembering that the state could have other motives than profit as an owner. Given the presence of such objectives, the expected rate of return for private investors could be lower than elsewhere in the financial market. In such instances, private co-ownership has to be based on a share of nonprofit motives, or a belief that the public co-ownership will entail other economic advantages.

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<sup>10</sup> Freely translated: State enterprise

<sup>11</sup> Freely translated: County enterprise

<sup>12</sup> Freely translated: Municipal enterprise

<sup>13</sup> Freely translated: Intermunicipal company

<sup>14</sup> Freely translated: Regional health authority

<sup>15</sup> Freely translated: Health trust

<sup>16</sup> Freely translated: Governmental stock company

## **2.3 Categorization of Nonprofit Organizations**

There are many ways to classify nonprofits. I would like to remind the reader that I refer to all organizations within ‘the third sector’ as nonprofits, whereas some authors classify them as a subclass. More precisely, my definition of nonprofit includes all organizations that are legally independent of the public sector and have other primer objectives than earning profits, excluding poorly governed forprofits. I will highlight three theoretical categorizations, as well as a legal based categorization. Other classifications are of course possible. For instance, Bielefeld and Galaskiewicz (2003) divide nonprofits into four groups based on the strength of their process and output controls, confer their macro-organizational theory treated in section 5.3.3. Another example is the demand based labeling related to the stakeholder approach, developed by Ben-Ner, Gui and Van Hoomissen, and reviewed in section 4.3.2.

Yet, I defend my choices of labeling by asserting that these classifications are both influential and illustrative for getting a clear overview over the complex nonprofit landscape. I begin by going through Weisbrod’s categorization in section 2.3.1. Next, I review Hansmann’s classification in section 2.3.2 and Ware’s classification in section 2.3.3. Lastly, I finish the subchapter and the chapter moreover, by drawing attention towards the legal based labeling of nonprofits in section 2.3.4.

### **2.3.1 Weisbrod’s Categorization of Nonprofits**

Weisbrod (1988) distinguishes between four types of nonprofits; clubs, collective-type nonprofits, trust-type nonprofits and ‘forprofits in disguise’. He points out that some nonprofit organizations are neither in the business life nor obligated to charity and idealistic work. Clubs are instead dedicated to provide some kind of benefits for their members. Labor unions and trade associations are examples of clubs that maximizes the welfare of their associated workers and shared interest organizations with weighted interests of their member organizations. Such associations typically gather the supplier side or the demand side of a market to achieve a better outcome for the group they represent, by affecting the price of the private goods in question. Another sort of clubs, like nonprofit-driven golf clubs, provides a club good to its member, i.e. a good characterized to a large distinct by excludability and non-rivalry.



Collective-type and trust nonprofit organizations, on the contrary, are identified by their significant contribution to the well-being of individuals outside the organization. Typical examples are organizations that strive for correcting market failures harming spread interests, like advocacy groups engaged in consumer rights and environmental issues. Common market failures in this regard are asymmetric information, the provision problem of public good and negative externalities with some degree of uniformity. Due to their potential market correcting features, the collective-type and the trust-type of nonprofit organizations more often receive tax benefits or other kinds of public support, than clubs do. While trust-type nonprofits provide costly and trustworthy information to the consumer concerning the quality of product, collective nonprofits produce public services. It follows that an environmental organization typically will be a collective-type nonprofit fighting for the public good in form of a healthy environment (ibid.).

On the other hand, a consumer organization, whose main concern is to provide information to its consumers, can be categorized as a trust-type nonprofit. Of course, consumer organizations could be engaged in the production of public services as well, for instance by providing assistance in case of consumer disputes. Furthermore, it remains a fact that some environmental organizations signal to what extent a group of products is eco-friendly. More generally, one could envisage organizations that are hybrids between clubs, on the one hand, and collective-type and trust-type nonprofits, on the other hand. These are societies that both look after its member's interests and common interests in general (ibid). Moreover, the size of the external group that gains from the collective nonprofit-organizations activities may vary. One could place many of the existing nonprofit organizations on a scale between member's interests and common interests. Yet, not all nonprofits could easily be placed along a scale of this sort, at least if we categorize them after their objectives directly.

Weisbrod highlights a fourth type nonprofit, which he calls 'forprofit in disguise'. If we had to place forprofit in disguise along our 'who-gains-from-the-activities-scale', it would obviously belong to the member's side. In contrary to clubs, however, it will with a underlying profit-driven motivation, try to mimic nonprofits and make use of the advantages that stems from the legal status. Besides, 'forprofits in disguise' could have basis in social harmful and even illegal activities. Possibly, only some few interior stakeholders would gain advantages from such rent-seeking behavior (ibid.). With references to section 6.1.3, it seems clear that the possibilities deplete the concerned nonprofit for fundings or exploit it to achieve

tax benefits would be motive for operating a ‘forprofit in disguise’. Later on, we will see in subchapter 4.1 that Weisbrod’s collective type nonprofit is descriptive for his own public good approach. Furthermore, we will note that the trust-type nonprofit fits Hansmann trust approach, reviewed in subchapter 4.2. All the three well-functioning types of nonprofits fit the stakeholder approach, developed by Ben-Ner and other, and discussed in subchapter 4.3.

### **2.3.2 Hansmann’s Categorization of Nonprofits**

Henry Hansmann (1980) has established another categorization of nonprofit organizations, which is much used in the literature. He divides the nonprofits along two dimensions; one control dimension and one patron dimension. Nonprofits’ core patrons could be based on donations or commercial activities. In terms of control, Hansmann distinguishes between ‘entrepreneurial’ nonprofits and ‘mutual’ nonprofits. The former type is controlled by their beneficiaries, whereas the latter is controlled by some administrators, severing the entrepreneur interests more loosely. As examples, Hansmann mentions political clubs as donative mutual nonprofits; country clubs as commercial mutual nonprofits; art museums as donative entrepreneurial nonprofits; and nursing homes as commercial entrepreneurial nonprofits.

It should be noted that Hansmann excludes cooperatives, mutual banks and mutual insurance companies and other mutuals from his definition of nonprofits. This is because they often violate his non-distribution constraint, which implies that nonprofits are prevented from distributing profits (*ibid.*) (see section 4.2.1 and section 6.1.2 for more about this constraint). Hansmann’s narrow definition of nonprofits also resemblances the ones applied in the legislations of many Western countries. Analyzing nonprofit financing, Wilsker and Young (2010) find that nonprofits often use a wide variety of income sources. From this observation, they conclude that Hansmann’s distinction between donative nonprofits and commercial nonprofits might be too drastic. Yet, Hansmann’s categorization plays an important role in many aspects of the study of nonprofits, *inter alia* in the stakeholder theory (confer section 4.3.2) and when analyzing nonprofits’ cooperate financial side (confer subchapter 7.2). In addition, the labeling is useful when investigating nonprofits’ interior incentive structures (confer chapter 6); particularly with regard to control rights, moral hazard and rent seeking (confer section 6.1.1 and section 6.1.3 respectively).

### 2.3.3 Ware's Categorization of Nonprofits

As Hansmann, Ware (1989) does not use 'the nonprofit sector' as a term for the whole third sector. Instead, he defines all organizations other than the state and the forprofit organizations as 'intermediate organizations'. Ware divides intermediate organizations into four groups. Those are charities (including legally charitable voluntary associations), mutual organizations (e.g. cooperatives, trade unions and mutual benefit voluntary associations), political groups (e.g. political advocacy groups and political parties) and associations that do not fit the previous groups (these are often too small to have a legal body). Ware claims that 'nonprofit organization' is a blurry term that cut across his categories. In his terminology, nonprofits generally constitute organizations that operate in the business life. Yet, he underpins that the borderline is unclear, seeing that intermediate organizations to various extent are engaged in different operations with various elements of commercial activities. I have included Ware's categorization in my review, because I think it illustrates the complexity of the third sector.

### 2.3.4 Legal Based Categorization of Third Sector Organizations

I now turn to a legal based classification of nonprofits. Although the legal forms differs between countries and many special cases exist, I believe it is useful to distinguish between four subclasses; associations, cooperatives, foundations and mutual companies. Note that cooperatives and mutuals share many characteristics, except for legal ownership. Moreover, cooperative is the only one of the nonprofit institutional forms, which is not self-owning.

#### Foundations

A *foundation* is a categorization of nonprofit organizations, which are set up by a person or a group of private persons through a testament. This testament forms the ground rules and the purpose of the organization. Each foundation constitutes a legally independent person. The categorization of foundations in the literature seems somewhat inconsistent. As nonprofit organizations in general, foundations are engaged in a wide range of activities – from business operations and family matters – to charity. I propose to categorize foundations into interest foundations, charity foundations, business foundations and hybrids. Interest foundations could advocate the interests of larger mutual groups, or they could protect the narrow interests of a very small group; for instance a rich family, which wants to avoid high

taxation. Furthermore, charity foundations engaged in philanthropic activities and could be either publicly or privately financed. Public foundations are often established by the public sector to achieve less political sensibility and more independency for a given purpose.

Lastly, business foundations are foundations operating in the business life – most often in the traditional nonprofit industries, but occasionally also in industries where the nonprofit rationales are less striking. Hansmann and Thomson (2009) define industrial foundations as private foundations, which own business companies. Saving banks constitute a special case within the group of business foundations (or occasionally mutuals), having an own legal form in many countries (Meinich 2009). In Norway, a foundation is known as a *stiftelse*.<sup>17</sup> By Norwegian law, this organizational form is divided into ordinary foundations and business foundations (The Norwegian Minister of Justice and the Police 2011c). Norwegian business foundations must have at least NOK 200,000 in equity when established, whereas the requirement is NOK 100,000 for other types of foundations (Knudsen 2009c).

## Cooperatives

*Cooperatives* are characterized by membership control and ownership, as well as distribution of the surplus to their members. Their members can constitute a wide range of beneficiaries, including customers, retailers and workers, as well as residents in housing cooperatives. If it is meant to serve its workers, it is called a worker cooperative. In a worker cooperative, the workers' utility from inducing effort and gaining money is maximized, possibly overcoming moral hazard issues. If the cooperation is meant to serve its customers, it is called a consumer cooperative, and the market surplus is maximized for the sake of the consumer, and so on.

Due to their distribution of profits, many authors do not recognize cooperatives as nonprofit organizations (e.g. Hansmann 1980). For instance, it is hard too find substantial differences between a small working cooperative and a small private partnership, where everyone is partners. Yet, cooperatives generally seek to serve their interest group more broadly than just profit. In Norway cooperatives are called *Samvirkeforetak (SA)*<sup>18</sup>, and the beneficiaries mainly have full liability. An earlier legal form of cooperatives with limited liability, called

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<sup>17</sup> Freely translated: Foundations

<sup>18</sup> Freely translated: Cooperatives

*Samvikeforetak med begrenset ansvar (BA)*<sup>19</sup>, will be closed from January 1<sup>st</sup> 2013. Besides, the transnational legal form ‘European cooperatives’ is recognized also in Norway, as well as in the rest of the European Economic Area (Altinn 2012d).

## **Mutuals**

Another category of money-distributing nonprofits is called *mutual companies* or just *mutuals*, encompassing inter alia mutual insurance companies and mutual savings banks. While cooperatives are owned by their beneficiaries, mutuals are legally independent persons, like foundations (Hansmann 1988). As for cooperatives, many authors do not recognize mutuals as nonprofits, because they violate the non-distribution constraint (see for instance Hansmann 1980). In Norway, saving banks have their own legal form, which includes mutual saving banks (Meinich 2009). Other mutuals are organized as ordinary foundations with statutory objectives directed toward a particular beneficiary group’s well-being.

## **Associations**

*Associations* constitute a diverse group of organizations in both scale and scope. They are usually less involved in business activities than foundations, and control rights are commonly obtained by membership. Non-governmental organizations are sometimes used as a synonym for associations independent of the government. More generally, non-governmental organizations are commonly divided after orientation (charitable, empowering, participatory and service) and level of cooperation (community based, city wide, national and international) (Frandsen and Lawrey 2010). Non-governmental organizations are occasionally treated as an own group of third sector entities, rather than a subgroup of nonprofits. Steinberg (2003) pins out that labor unions, political parties and sport leagues, as well as trade unions and civic associations, usually are bounded from distributing profits. Yet, these organizations have gained little attention in the nonprofit literature, and they will unfortunately not be the focus of my thesis either. In Norway, the general associations are registered as *foreninger*.<sup>20</sup> Some associations, like student unions and housing associations, are subject to specific Norwegian laws (Altinn 2012e).

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<sup>19</sup> Freely translated: Cooperation with limited liability

<sup>20</sup> Freely translated: Associations

## **3 The Nonprofit Landscape**

In this chapter, I outline the development of the nonprofit sector worldwide. My aim is to give some reference points before starting on the theories, rather than to provide a complete and representative overview. I begin by looking at the sector's history in subchapter 3.1, before I discuss the modern nonprofit landscape with references to the social origin approach in subchapter 3.2. Thereafter, I turn to the Norwegian nonprofits in subchapter 3.3. I round off the chapter by providing some predictions for the future nonprofit sector in subchapter 3.4.

### **3.1 A Glimpse of the Nonprofit Sector's History**

The nonprofit sector is far from a new phenomenon. Since ancient times, people have formed and joined societies to ensure mutual interests and distributive justice. For instance, Buddhist temples and ministries in Ancient China provided social services, including feeding stations for poor people, hospitals and nursing homes. In Europe, the states remained weak for more than a thousand years after the Roman collapse. Consequently, European nonprofits faced difficulties in providing alleviation in case of disasters, whereas the Chinese state established granaries to prevent famine and limit the rise in grain prices in case of harvest. Mutual benefit organizations other than protection guilds remained difficult to establish up to the renaissance, so the nonprofit sector around the world was largely philanthropic, with the Catholic Church as a driving force in Europe. During the renaissance, the European churches were supplemented by other philanthropies, and gradually, also by mutual nonprofits. As the trade unions' forerunners, friendly societies started to become common in Europe around 1700, while various forms of cooperatives emerged throughout the preceding century. In the mid-1800s, corporations seized the position as the prevailing organizational form in the Western business sector. Nevertheless, nonprofits and other organizational forms continued possessing significant sectorial shares in many sectors (Ware 1989).

### **3.2 The Modern Nonprofit Landscape**

Examining an empirical study on twelve countries around the world, Anheier and Salamon (1996) find that three fourths of the voluntary based nonprofit sector expenditures are related

to four major fields.<sup>21, 22</sup> These are culture and recreation (e.g. arts, media, service clubs and sports), health (e.g. hospitals and nursing homes), knowledge (e.g. education and research) and social services (e.g. child care, emergencies, income support and refuge assistance). Anheier and Salamon neglect political and religious organizations from their analysis. In addition, they exclude nonprofits without a voluntary element from their study. Emphasizing a broader definition of nonprofits, one should note that nonprofits are usual in certain other industries as well. In particular, many European groceries are cooperatives (see for instance Coop Norge SA 2012 and The Co-operative Group 2012), while mutuals are common in the banking and insurance industries (see for instance GjensidigeStiftelsen 2012, Hansmann 1980 and The Norwegian Saving Bank Association 2012a). Besides, foundations often play an important role in the provision of certification and classification services (see for instance DNV (2012), Fair Trade International (2012) and World Fair Trade Organization (2012)).

Today, the world largest transparently operating nonprofit is the American foundation named Bill & Melinda Gates Foundation (2012) (Davies et al. 2008). The foundation engages in philanthropy activities and was founded by the Microsoft founder, Bill Gates, and his wife, Melinda Gates. Yet, some analysts have speculated that the IKEA Foundation (2012), associated with the home product supplier IKEA, is even wealthier than Bill & Melinda Gates Foundation (see for instance The Economist 2006). Furthermore, the world's largest cooperative is The Co-operative Group (2012), which is a British and consumer-based grocery chain. Other well-known nonprofits are the Carlsberg Foundation (Carlsberg Group 2012b), Ford Foundation (2012), the International Red Cross and Red Crescent Movement (2012), The Nobel Foundation (2012), Wikimedia Foundation (2012) and W. K. Kellogg Foundation (2012) and Wellcome Trust (2012). Besides, the European Network of National Civil Society Associations (2012) encompasses civil societies from 23 countries, whereas the world's organization for civil societies, CIVICUS (2012), is represented in more than 100 countries.

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<sup>21</sup>The Johns Hopkins Comparative Nonprofit Sector Project is headed by the Institute for Policy Studies at John Hopkins University in the United States. The twelve countries in the referred study compromise Brazil, Egypt, France, Germany, Ghana, Hungary, Italy, Japan, Thailand, the United Kingdom and the United States.

<sup>22</sup> Anheiner and Salamon define nonprofits as organizations that are formally constituted, organizationally separated from the government, not profit-seeking, self-governing and voluntary to some extent. The latter criteria obviously excludes some nonprofit in the business sector. In addition, the authors neglect religious and political groups (see for instance Anheiner and Salamon (1996) or Anheiner (2003)).

In an empirical investigation of nonprofits with a voluntary element, Anheier and Salamon (1996) identify four different regimes of nonprofits on the basis of two social origins factors, namely the magnitude of the countries' public spendings on social welfare and the size of their nonprofit sectors (see for instance Anheier 2003, Anheier et al. 2000, Anheier and Salamon 1996). First, the liberal regime is characterized by low public social welfare spendings and large nonprofit sectors, which typically follows from a growing middle class and lack of a labor moment (e.g. Australia and the United States). Second, the social democratic regime represents the opposite case, where labor class have gained acceptance for public welfare arrangements, and the third sector are engaged in personal expression, rather than service provision (e.g. Finland and Sweden). Third, both factors are large within the statist regime, where the public uses nonprofits to engage in alliances with key social elites to limit radical social welfare demands (e.g. Germany and the Netherlands). Fourth and last, both factors are small in the statist regime, where deference-driven traditions make the public sector more reluctant (e.g. Brazil and Japan). Personally, I find Anheier and Salamon's social origin approach highly relevant for the discussion on whether the public sector and the third sector are compliments or substitutes under different circumstances (confer section 7.1.2).

In the beginning of the 1990s, The Johns Hopkins Comparative Nonprofit Sector Project was implemented by researchers at Johns Hopkins University in order to map the nonprofit landscape worldwide. Moreover, they found that the nonprofit sector paid and voluntary employment rose significantly in most countries around the world between 1990 and 1995. Paid employment increased from 3.7 to 4.9 percent in Germany, from 2.5 to 3.5 percent in Japan, from 2.5 percent to 2.6 in Sweden and from 6.9 percent to 7.8 percent in the United States. Similarly, voluntary employment rose from 13 to 26 percent for Germany, from 36 to 51 percent for Sweden and from 37 to 49 percent for the United States (Anheier 2003, Anheier and Salamon 1996). In light of these numbers, I believe it would have been interesting to investigate how the nonprofit sector's relative magnitude varies with the business cycles. Moreover, the ongoing global financial crisis has had equivocal effects on the nonprofit sector; a matter I will return to soon.

In 1990, the nonprofit operating expenditures as percentage of GDP were significant in most countries, including Germany (3.6 percent), Japan (3.3 percent), Sweden (3.2 percent) and United States (6.4 percent). Furthermore, the numbers of nonprofits per 100,000 inhabitants were 456 for Germany, 70 for Japan, 1,463 for Sweden and 412 for the United States



(Anheier 2003). Empirics indicate a substantial growth in the American nonprofit sector. The tendencies are the same in Europe, although the trend is somewhat ambiguous in some sectors, particularly with regard to employment (Badelt 2003). Anheier and Salamon (1996) find a joint growth rate of 13 percent in France, Germany and the United States from 1980 to 1990. In general, several studies during the 1980s and 1990s show increased employment rates and revenues for nonprofits in Western countries. In many cases, the nonprofit outperformed both public and private enterprises (Bacchiega and Borzaga 2003).

Anheier and Salamon (1996) point out how the Hungarian nonprofit sector<sup>23</sup> raised from being almost non-existence in 1990 (just after the collapse of the Soviet Block) to account for 20,000 organizations and 3.2 percent of all service jobs in 1995. Moreover, most Eastern European countries lie in between the statist and the social-democratic regimes (Anheier et al. 2000). As a typical development country, the Ghanaian nonprofit sector is characterized by a series of unregistered self-supporting societies, non-governmental organizations, religious charity organizations and business associations (Anheier and Salamon 1996). Furthermore, the Brazilian nonprofit sector has been growing considerably since the 1970s, consisting of exclusive private schools, larger hospitals, professional associations and numerous of unregistered community associations and advocacy groups (Anheier and Salamon 1996, Anheier et al. 2000). In the 1990s, the Egyptian third sector consisted by a mixture of Cyoptic, Islamic and Western nonprofits, but its growth rate was somewhat subdued by the country's political situation (Anheier and Salamon 1996). The Thai nonprofit sector, on the other hand, has experienced a sustainable growth since the end of its dictatorships (Anheier and Salamon 1996). In general, developed countries have historically had a relatively larger nonprofit sector than developing countries (Anheier and Salamon 1996, Anheier et al. 2000).

Badelt (2003) refer to an earlier study on European Welfare states, where he finds that most new social services are established in the nonprofit sectors (e.g. social works for immigrants and homes for abused women and children). He underlines the extensive use of volunteers and self-employment in these countries. Historically, new nonprofit industries are often gradually taken over by the public. At the same time, the reverse trends have also been observable, for instance in form of privatization targeted to consolidate public budgets (ibid.). Anheier and Salamon (1996) find support that the cooperation between the public sector and

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<sup>23</sup> I remind the reader that Salamon and Anheiner exclude religious nonprofits and nonprofits without a voluntary element.

the nonprofit sector has been increasing both in Germany and the United States. They observe that government supports are particularly large in France and Germany.

In general, the first decade of the 21<sup>st</sup> century was characterized by continuing global expansion of the nonprofit sector. A growth in the demand for nonprofit goods and services was accompanied by weaker public finances. When the global financial crisis hit the world economy in 2008, the financing of and voluntarism in nonprofits was impeded, *ceteris paribus* decreasing the supply of nonprofits. Right after the financial crisis emerged; Keynesian policies increased the public sector, suppressing the nonprofit sectors even more. Due to large public deficits, however, the public sectors soon dismantled in many developed countries, implying increased demand for nonprofit services. Yet, the expected increases in demand for nonprofit services have been overestimated by many foundations, and the required rates of return for nonprofits have generally increased. In addition, public policies have been directed to encourage private giving for public purposes, while philanthropic foundations have seen drops in asset values of scales not seen in many decades (Anheier 2009).

Geller et al. (2010) find that nonprofits are rather innovative and adaptive to technological changes, but that their innovative strengths are limited by their resource restrictions. Furthermore, Badelt (2003) point to studies that indicates that professionalization of the nonprofit sector is higher in the United States than in Europe, although there were significant improvements in European nonprofit sector around the turn of the millennium. He also refers to studies which conclude that the growing literature on the third sector have given nonprofits a better image within European management circles, after the sector earlier was perceived as somewhat unprofessional. The professionalization trend continued over the first decade of the new millennium (Anheier 2009). According to Bacchiega and Borzaga (2003), the American nonprofit sector has been increasingly commercialized, while the European nonprofit sector overall has become more stable and continuous. Most recently established nonprofits in Europe have been mostly cooperatives and associations, and to little extent non-proprietary forms in the business sector characterized by the non-distribution constraint (confer section 4.2.1). While cooperatives have started to engage themselves more in social matters, associations have developed to become more innovative and productive (*ibid.*).

In Denmark, foundations own and operate about a quarter of the country's hundred largest companies and control close half of the major Danish stock index's (KFX) value. Similar

structures were usual in the United States up a law introduction in 1969, which prevented and still prevents foundations in the country from owing more than twenty percent of business companies (Hansmann and Thomson 2009). Bielefeld et al. (2006) find that donative nonprofits' growth rate during the first decade of the millennium was dependent on strong ties to urban elites and other organizations, such that they easier could attract contributions and volunteers. On the contrary, they found that commercial nonprofits grew faster with fewer ties to the local elite and other nonprofits.

The link between a citizen and different formal organizations are often weak; and this is typically also the case for the citizens' loyalty towards a particular organization. Moreover, these links varies across countries. For instance, many European nonprofits play a direct role in connecting people with policy and society, while this interaction is more loosened in the United Kingdom and the United States (Ware 1989). Wolch (2003) accentuate nonprofits central role in popular movement, and how many of them can be considered as an expression local affiliation. Furthermore, she highlights the importance of globalization for the development of the nonprofit sector. On the one hand, she pins out the limitations in the abilities to regulate, support and tax nonprofit organizations, among both international trade agreements and the national states. On the other hand, she point that the new possibilities regarding nonprofit cooperation across countries and multilateral initiatives.

### **3.3 Norwegian Nonprofits**

In Norway there are 8,000 foundations, including 1,000 business foundations and 7,000 nonprofit foundations in the legal sense (confer the subsection about foundations in section 2.3.4). The Foundation Authority estimates the Norwegian foundation to have an equity capital somewhere between NOK 50 billion and NOK 100 billion (The Norwegian Gambling and Foundation Authority 2012). According to Dugstad and Lorentzen (2010), one third of the Norwegian foundations are distributing their surplus. They find that most of the surpluses are donated to education and research purposes, and categorize the remaining foundations as operative foundations. Dugstad and Lorentzen argue that the borderline between associations and foundations' activities is unclear. The Norwegian registered voluntary sector is organized

through the Association of Non-Government Organizations in Norway<sup>24</sup> (2012), which accounted for 115,000 legal nonprofit organizations and non-government organizations. The organizations combined have 10 million memberships, which is twice as many as the number of inhabitants in Norway. 80 percent of the Norwegians are members of more than one organization.

The biggest legal foundation in Norway is GjensidigeStiftelsen (2012), which owns 63.15 percent of the Norwegian insurance company, Gjensidige Forsikring. GjensidigeStiftelsen is a mutual company. It is controlled by and gives its surplus to its customers. In 2010, the payouts approximately amounted to NOK 1.6 billion. There are also many saving banks in Norway, constituting three major groups (i.e. the DNB NOR Savings Bank Foundation,<sup>25</sup> SpareBank 1 Gruppen and Terra Gruppen), as well as some independent saving banks (The Norwegian Saving Bank Association 2012a, The Norwegian Saving Bank Association 2012b). Furthermore, one of the four large grocery chains in Norway, Coop Norge SA (2012), is a consumer cooperative, which had more than 1,250,000 members in 2010.

Another large foundation is Fritt Ord<sup>26</sup> (2011a, 2011 b), which highlights freedom of expression and constitutes a major investor in the Norwegian business sector. Norway also has many large foundations engaged in education and research (e.g. BI Norwegian Business School<sup>27</sup> (2012), Competence Development Fund of Southern Norway<sup>28</sup> (2012), SINTEF (2012) and UNIFOR (2012)). Other notable foundations include Cultiva (2012) (culture), Det Norske Veritas (DNV 2012) (maritime and energy related services), Diakonhjemmet Foundation<sup>29</sup> (2012) (education, health and research), Hennie Onstad Art Center (2012) (arts), Kavli Trust<sup>30</sup> (2012), (food), Norwegian Air Ambulance<sup>31</sup> (2012) (emergency and rescue services), Signo (2012) (social welfare services for deaf and deafblind) and Zero Emission Resource Organisation (2012) (environmental protection with focus on climate changes).

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<sup>24</sup> Norwegian name: Frivillighet Norge

<sup>25</sup> Norwegian name: Sparebankstiftelsen DNB NOR

<sup>26</sup> Freely translated: Word of Freedom

<sup>27</sup> Norwegian name: Handelshøyskolen BI

<sup>28</sup> Norwegian name: Sørlandets Kompetansefond

<sup>29</sup> Norwegian name: Diakonhjemmet Stiftelse

<sup>30</sup> Norwegian name: Kavlifondet

<sup>31</sup> Norwegian name: Norsk Luftambulans

### 3.4 The Future Trends of the Nonprofit Sector

Unaware of the upcoming global financial crisis, Ben-Ner and Gui (2003) predicted that the nonprofit sector would continue to populate the economic landscape, although restrained by institutional inertia. They asserted that the demand for nonprofits is continuously evolving, and that no uniform future trend could be forecasted. Furthermore, they thought that increased competition or more regulations would decrease the presence of nonprofits in some traditional nonprofit industries. Contrary, they argued that less government provision of welfare services and increased demand for immaterial, sophisticated and relational goods would increase the demand for nonprofits. This would especially be the case for mutual nonprofits, where stakeholders cooperate in controlling the company, opposed to entrepreneurial nonprofits (confer Hansmann's labeling, reviewed in section 2.3.2). The nonprofit's expansion would according to the authors be limited by supply through lack of entrepreneurs and donors (ibid.)

Another pre-financial crisis prediction was made by Anheier (2003). He forecasted a sustainable growth in the third sector; but had too strong belief in the growth in the voluntary segments. Furthermore, Anheier suggested that more privatization, new public management and need for innovations related to social services would result in major challenges for the sector. Moreover, Anheier believed that nonprofit would face an increasingly demand from a variety of stakeholders, and that they would take over tasks from both the private and the public sector. In addition, he foretold that a decreased government support would push nonprofits into commercial activities. He predicted them to become more similar to forprofits; particularly in the United States. At last, Anheier found that the nonprofit sector's expansion was not only a matter of size and scope, but also an expression of evolving institutional forms.

In my opinion, most of these predictions continue to stand strong under the current debt crisis in Europe, Japan and the United States. Many of them, like tightening of nonprofit finances and smaller public sectors, are from my point of view even strengthened. As noted in subchapter 3.2, the shirking of financing in the third sector limits the nonprofits' supply. However, if the public deficits and aging populations force developed countries to downsize their public sectors, it seems reasonable to expect that the demand for nonprofits would grow. These trends are less striking for certain parts of Northern Europe. Lastly, I predict that economic progress will increase the nonprofit sectors in developing countries. In many Arabic countries, democratization is likely to contribute to larger nonprofit sectors.

## 4 Theory of Demand for Nonprofits

The approaches to nonprofits are commonly divided into two groups; the demand approaches and the supply approaches. The division is not absolute; it is more of a guideline for where the core focus of the approach lies. In general, I argue that the approaches to nonprofit should largely be viewed as complementary to each other, rather than mutually exclusive. In this chapter, I focus on the demand approaches to nonprofits. I begin by reviewing the public good approach based on Weisbrod's path-breaking paper from 1975 in subchapter 4.1. Next, I turn to the trust approach, which stems from Hansmann's influential paper from 1980 in subchapter 4.2. At last, I present the stakeholder approach in subchapter 4.3; an interesting attempt to unify the approaches to nonprofits developed by Ben-Ner and his coworkers; primarily Gui and Van Hoomissen.

### 4.1 The Public Good Approach

In this subchapter, I will embrace the public good approach to nonprofits, originally formulated in a publication from 1975 by one of the pioneers within the nonprofit literature; Burton Weisbrod. I will start out by going through Weisbrod's public good approach in section 4.1.1. Next, I will discuss some extensions and modifications that have been made in the subsequent literature in section 4.1.2. Thereafter, I will further develop Schiff and Weisbrod's (1981) version of James' (1983) model in section 4.1.3, which involves a nonprofit's cross-subsidizing of a public good by sales of a private good. In the latter subsections of the section, I extend the model to emphasis competition with forprofit, dynamic properties and green worker characteristics. At last, I end this subchapter by providing some criticism to Weisbrod's public good approach in section 4.1.4.

#### 4.1.1 Weisbrod's Public Good Approach

Weisbrod's influential public good approach stems from his influential paper '*Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy*' from 1975 (revised in 1988). It is often considered as a cornerstone in the nonprofit literature (see for instance Kingma 2003). The approach combines various earlier explanations for how public good provision problems are solved by collective action of the affected individual. These

includes Coase Theorem from 1960 (i.e. externality internalization through efficient bargaining) (Kingma 2003), Black's median voter theory from 1948 (i.e. public actions will respond to the median voter's preferences) (Slivinsky 2003), Buchanan's theory of club goods theory from 1965 (i.e. optimal club membership) and Olson's theory of collective action, also from 1965 (i.e. benefits and cost of public good provision) (Kingma 2003).

In his 'government failure argument', Weisbrod (1975) highlights nonprofits' ability to supply of certain public goods; a supply that forprofits and public enterprises largely fail to provide. According to Weisbrod, the public sector will have to take the median voter into account in terms of his willingness to pay taxes and his demand for different public goods. In short, the government's provision of public goods is determined by a political mechanism, which acts in accordance with the median voter's preferences. Consequently, Weisbrod stresses that efficiency, in the sense that the social marginal benefit equals the marginal cost of production, is unlikely to be fulfilled. Furthermore, public goods are typically not provided by private firms due to a combination of the free-rider problem of public goods and perverse incentives. Weisbrod argue that forprofits' provisions of public goods lack both quality and quantity, as well as the diversity in the range of goods.

In Weisbrod's original model, donors secure a nonprofit's production of a single public good. Following the model framework, more donative financing necessarily leads to more provision. Thus, the original model is most suitable for donative nonprofits. Weisbrod argues that nonprofits have a role in satisfying the unsaturated demand of public goods. The remaining gap will be filled by a donative financed nonprofit sector. The donations in his model are private in nature. He mentions three reasons for how nonprofits overcome the free-rider problem; a social glow, social pressure and altruism. Following the model framework, more donations necessarily leads to more provision of the public good (ibid.).

An important implication of Weisbrod's model is that it predicts that the nonprofit sector will be larger in communities with more heterogeneous preferences among the inhabitants. This is both because there are more consumers, who deviate from the median voter in their preferences, and because these interest discrepancies are bigger (ibid.). Kingma (2003) refers to empirical support for nonprofit sectors being larger, when there are larger variations in age, education, income and ethnical background. Weisbrod (1988) himself introduce a collectiveness-index for degrees of collectiveness among the goods produced based on

donations' percentage of total income (see subchapter 7.1 for more on sources of income). Moreover, he argues that larger propensity for donations aimed for public good provision among donors results in nonprofits that are more dependent on donations. Weisbrod underpins his hypothesis by empirical support.

Furthermore, Weisbrod (1975) claims that direct or indirect subsidies of nonprofits (e.g. corporate tax exemptions, tax deduction on donations and other sorts of tax benefits) could be a reason for nonprofit firms. Obviously such support arrangements would benefit the nonprofits concerned, opposed to forprofits. Potential intruders would also gain more by evading the nonprofit organization (confer section 6.1.3). However, justification for tax advantages for a nonprofit is not necessarily valid. From an efficiency point of view, one should only favor nonprofit enterprises in the tax system, if one attains a social gain from doing so. It seems reasonable that voluntary charity work and efforts to overcome market failures could justify such favoritism, since these services are likely to be underprovided. Whether such justification is present in the case of commercial nonprofit or clubs is rather indistinct. Weisbrod emphasizes that various support arrangements for nonprofits are characteristics of the tax system, rather than the nonprofits as an organizational form.

#### **4.1.2 Extensions of Weisbrod's Public Good Approach**

Extensions of Weisbrod's approach in the preceding literature embraces altruistic behavior (confer subchapter 6.2), possible integration with Hansmann's trust approach (confer subchapter 4.2), rationales for nonprofit entrepreneurship (confer subchapter 5.1) and a variety of stakeholders with partly conflicting interests (e.g. customers, donors, employees, managers and volunteers) (confer subchapter 4.3). Many of these models maintain donations as a key feature (Kingma 2003). According to Kingma (2003), donative nonprofits that provide a public good are dependent on the altruism of their donors. Kingma distinguishes between 'pure altruism', where the only donors receive benefits from increased public good provision, and 'impure altruism', where the donors also benefit privately from their contribution (e.g. control over the nonprofit output, social glow, social status and sponsorship). (For more on alternative behavioral conducts, see for instance Nyborg and Rege 2003).

Some extension of the approach incorporates interior matters of the organization like both managers' quest for perquisites (confer section 6.1.3) and green worker donations (confer



section 6.2.6). What is more, many succeeding modelers modify Weisbrod's donative public good provision, by including production of several private and public goods, possibly without donations. A conceivable alternative to Weisbrod's original modeling is to model the output as a private good with a positive externality, rather than a public good, allowing for profits and nonprofits to be in the same market. Furthermore, Sinitsyn and Weisbrod (2008) find that the profitability of taxed 'unrelated business activities', carried out for cross-subsidization purposes, often are underreported, in order to avoid large tax payment. In section 4.2.2, I will provide a compression of Kingma's (2003) discussion about possible integration between Weisbrod's public good approach and Hansmann's trust approach, where the combination of profit motivation and asymmetric information concerning the goods provided create perverse incentive for the forprofits (ibid.). In the following section, I will further develop a public good model of Schiff and Weisbrod by investigating implications for the organizational forms of various characteristics, and integrating features from green worker theory. In this model, nonprofit in question cross-subsidizes the public good by selling a private good.

#### **4.1.3 Schiff and Weisbrod's Public Good Model Extended**

In this section, I adapt Schliff and Weisbord (1991) version of James' (1983) model, as a starting point for my analysis. In the model, the nonprofit management cross-subsidizes a free public good by selling a private good, which it possibly dislikes. By doing this, they explain how nonprofits could be involved in profit-generating activities, even if profit is not a goal by itself. One way to formalize the nonprofit organization's adaption is to assume that it maximize some utility function given a break even constraint. Schliff and Weisbord (1991) formalize how forprofit and nonprofit compete in a market, where the existence of nonprofit are characterized by donations, provision of public goods, quality differences and tax exemptions. I will neglect tax exemptions in my model version, because I believe that the comparative advantages tax exemptions create, easily could be explained by traditional economic theory, without having nonprofit as necessary feature. Instead, I extend the model to discuss the sustainability of non-donative nonprofits in competition with forprofits. I integrate green worker theory to the formal modeling of nonprofits and discuss how these types of model can illuminate characteristics of the American university sector.

## Model Framework

In accordance with Schiff and Weisbrod (1993), I introduce an utility function  $U(z, x)$ , where  $z$  is some public good, which the nonprofit provides, and  $x$  is a private good, which is sold to an exogenous market price,  $p$ . I assume that the management's utility is increasing in the provision of the public good (i.e.  $U'_z > 0$ ) and non-increasing in the private good (i.e.  $U'_x \leq 0$ ). I suggest that the underlying rationale behind this could be that the management's utility function actually depends on the directors' fee,  $F = F(x, z)$ , where  $F'_1(x, z) \leq 0$ , and  $F'_2(x, z) > 0$ , such that  $U'_F > 0$ . We assume that management behaves in accordance with the statutes and thereby disregard interior moral hazard problems.

Considering the case where the private good has no positive impact on the nonprofit's utility, it looks logical that the only reason for producing  $x$ , must be to satisfy some financial constraint. Although surplus and deficit can be accumulated in the short run, it seems reasonable that the nonprofit should break even over a longer period. The corresponding non-distribution constraint could be written as follows:

$$(4.1) \quad D(z, x, S) + px - C(z, x) - S = \bar{F}$$

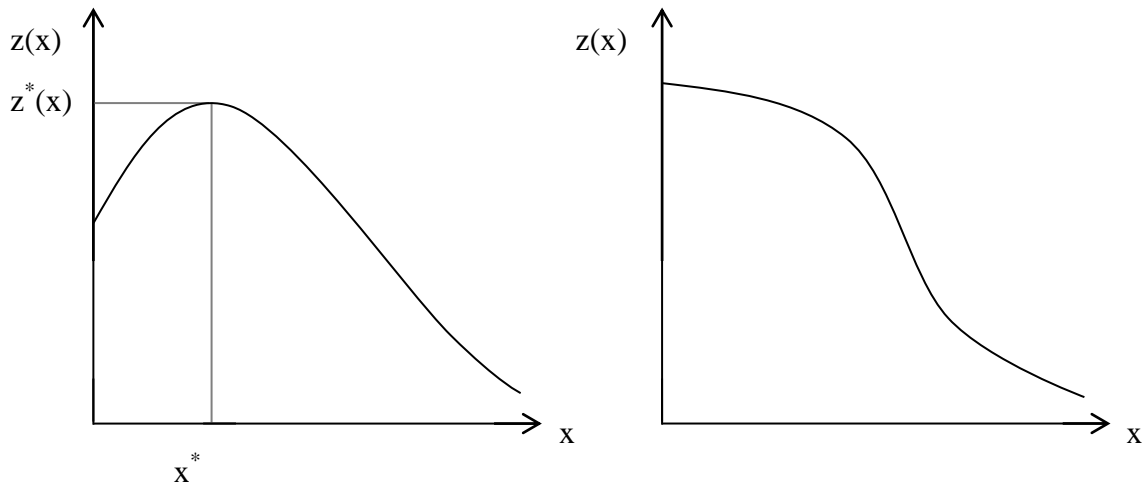
where  $\bar{F}$  is a fixed director's fee,  $S$  is the solicitation expenditures,  $D(*)$  is the donations and  $C(*)$  is the firm's cost function. The donations,  $D(*)$ , depends on the production of the two goods and the solicitation expenditures, while the firm's costs,  $C(*)$ , depends on the production of the two goods alone, possibly allowing economics of scope. I assume that the public good always is produced (i.e.  $z > 0$ ), whereas the private good may or may not be produced (i.e.  $x \geq 0$ ).

More concretely, I assume that the cost function is increasing and convex in the production of both goods, i.e.  $C'_i > 0$  and  $C''_{ii} > 0$  for  $i \in \{1, 2\}$ . I do not assess whether there are scoop advantages, disadvantages, both depending on quantities of production, or if the productions of the two goods simply are independent. Next, I assume that the donors either do not respond to commercial activities or are crowded out by them, that is  $D'_1 \leq 0$  (confer the empiric evidence discussed in section 7.1.4). Furthermore, in line with Weisbrod's collectiveness-index argument (discussed in section 4.1.1), I assume that donations increase weakly, but diminishing with the provision of public goods, i.e.  $D'_2 \geq 0$  and  $D''_{11} \leq 0$ . What is more, I assume that an increase in solicitation expenditures attracts more donations, but that this

becomes gradually more difficult, i.e.  $D'_3 > 0$  and  $D''_3 < 0$ . At last, I assume that there will be no donations without solicitation, that is  $D(z, x, 0) = 0$ . For now, I do not assess the potential synergy effects of the three function variables on donations.

Although the non-distribution constraint given by equation (4.1) implies that there could be dominating synergic effects between  $x$  and  $z$ , I assume that an increase in one of them eventually implies a decrease in the other to secure that the problem has a solution.

Mathematically,  $z$  could be expressed as function of  $x$ , with the cost function, the donation function and the non-distribution constraint as the underlying bases. I assume that  $z(x)$  is quasiconcave and increasing in the interval up to a quantity  $x^*$ , and quasiconcave and decreasing in the interval after  $x^*$ .  $x^*$  becomes irrelevant if it is below zero. In that case  $z(x)$  is quasiconcave and decreasing in the first quadrant. The relationship between  $x$  and  $z$  is illustrated in figure 4-1 below.



**Figure 4-1:** This figure illustrates two possible relationships between  $x$  and  $z$ . The graph in the panel to the left assumes that there is a positive relationship between  $x$  and  $z$  until a turning point, before the relationship becomes negative, whereas the graph in the panel to the right assumes that the relationship is negative for all positive values of  $x$  and  $z$ .

## Solving the Basic Model

Let us first assume that the nonprofit produces both goods and that it receives donations.

Although I have done some different modifications, the basis model that I here start out with is in essence the same as Schiff and Weisbrod's (1991). Yet, the authors do take their formal analyze very far and focus on pricing of 'unrelated income goods'. James (1983) does a resembling analysis, but includes government donations and neglect solicitation costs. I will

start by using the original model to show implications of crowding out effects and different attitudes towards producing the private good. We assume that the nonprofit in question is a price-taker. I will return to the competition issues in the later subsections of this section.

The nonprofit's maximization problem becomes:

$$(4.2) \quad U(c) = \max_{z,x} U(z, x) \text{ given (4.1)}$$

The corresponding Lagrange function follows:

$$(4.3) \quad \mathcal{L} = U(z, x) - \lambda(D(z, x, S) + px - C(z, x) - S - c)$$

From the envelope theorem, we have that  $U'(F) = -\lambda$ , implying that the shadow price for the directors' fee must be negative.

Maximizing equation (4.3), gives the following first order conditions:

$$(4.4) \quad U'_z - \lambda(D'_z - C'_z) = 0 \Rightarrow \lambda = \frac{U'_z}{(D'_z - C'_z)} < 0$$

$$(4.5) \quad U'_x - \lambda(D'_x + p - C'_x) \Rightarrow \frac{U'_x}{\lambda} = (D'_x + p - C'_x) \leq 0$$

$$(4.6) \quad -D'_S + 1 = 0 \Rightarrow D'_S = 1$$

From equation (4.4), we see that we must have  $D'_z < C'_z$ . This means that the costs increase more than the donations, when the provision of the public good increases.

From equation (4.5), we see that the quantity chosen is not just a matter of marginal cost and prices, but also depends on the valuation of  $x$ , the effects on donations from commercial activities and the shadow price for the director's fee. I will elaborate this matter in the next subsection.

Equation (4.6) simply means that one more krone used on solicitation gives exactly one more krone of donations in optimum.

Eliminating  $\lambda$  in (4.4) and (4.5), we find the interior solution:

$$(4.7) \quad C'_x = p + D'_x - \frac{U'_x}{U'_z}(D'_z - C'_z)$$

Equation (4.7) says that the marginal production cost of  $x$  must be equal to the price adjusted for a potential crowding out effect and the valuation of the net cost reduction related to the provision of  $z$  that follows from the reallocation of the underlying input factors.

If both goods are produced, equation (4.7) could alternatively be written as:

$$(4.8) \quad \frac{U'_z}{U'_x} = \frac{(D'_z - C'_z)}{(D'_x + p - C'_x)}$$

Equation (4.8) implies that if both goods are produced, the marginal rate of substitution of utility should be equal to the marginal net gain of funding for the nonprofit. In other words, the amount of  $x$  the nonprofit are willing to produce to get one unit more of  $z$  should be the same as the amount of  $x$  the nonprofit has to produce to get one more unit of  $z$ .

## Choice of Quantity

By analyzing equation (4.7), we can see how the nonprofit's choice of quantity of  $x$  to cross-finance  $z$  will depend on the impact on the management's utility and the donations. James (1983) conducts a similar analysis, but focuses solely on the management's utility.

Implications for the effects between donations and commercial activities are discussed in short in section 7.1.4. An underlying assumption is that the nonprofit survives in the competition against the forprofits in the private good market; a matter I will return to in the following subsections. As long as the nonprofit creates a surplus, it will affect the provision of the  $z$  as well. I will now also consider the possibility of  $U'_x > 0$ .

If  $D'_x = 0$  and  $U'_x = 0$ , we get  $C'_x = p$ , i.e. the nonprofit adapts similarly as the forprofits in the market for the private good.

If  $D'_x < 0$  and  $U'_x = 0$ , we get  $C'_x < p$ , i.e. the nonprofit sets a lower quantity of the private good than the forprofits, due to a crowding out effect on donations.

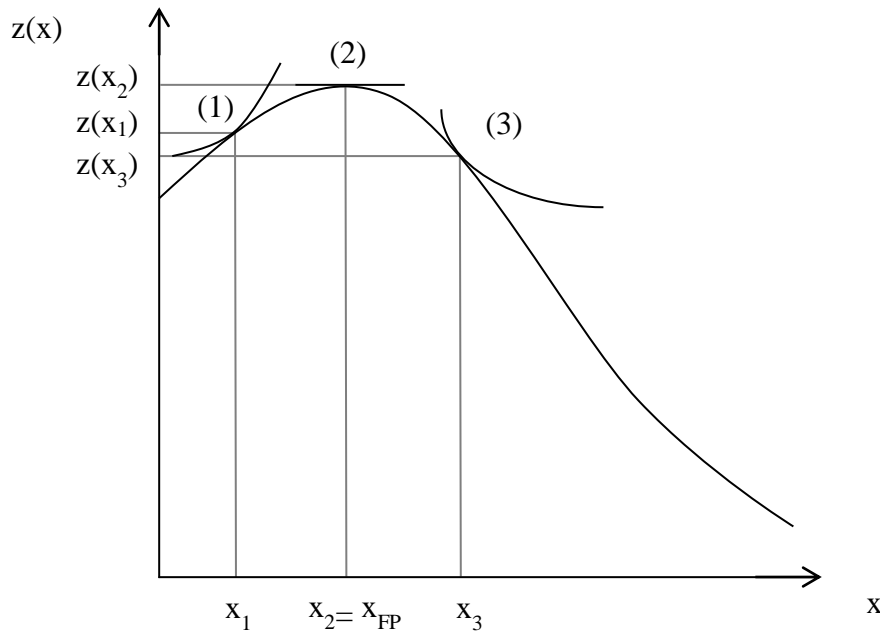
If  $D'_x = 0$  and  $U'_x < 0$ , we get  $C'_x < p$ , i.e. the nonprofit sets a lower quantity of the private good than the forprofits, due to a contempt for commercial activities within the nonprofit.

If  $D'_x = 0$  and  $U'_x > 0$ , we get  $C'_x > p$ , i.e. the nonprofit sets a higher quantity of the private good than the forprofits, because it perceives commercial activities as beneficial for the society.

If  $D'_x < 0$  and  $U'_x < 0$ , we will have  $C'_x < p$ , where both a commercial crowding effect and the management's aversion against commercial activities contribute to a low quantity of  $x$ .

At last, if  $D'_x < 0$  and  $U'_x > 0$ , the crowding out effect of commercial activities and the management's utility from production of the private good will give to contradictory effects, leaving the price level ambiguous.

I neglect the possibility that commercial activities should have a crowding in effect on donations from my treatment, although one may argue that some commercial activity could make the management appear more professional. The interpretations would be analogous to the ones above. I illustrate the possible adaptations in figure 4-2 below, before I investigate some special cases in the following subsections.



**Figure 4-2:** The figure shows three different cases. In case (2), there are no crowding effects, and the management does not care about the private good, so the quantity is the same as for the forprofit firms (given that the scale advantages are the same). In case (1), the management dislikes the private good and/or a crowding in effect is dominating, so that the quantity is set lower than the forprofit. In case (3), the management cares for the private good and/or a crowding in effect is dominating, so that the quantity is set higher than for the forprofit.

### Pure Donative Nonprofit

I will now investigate some special cases. Let us start out by considering the case where the aversion against commercial activities is large, possibly both among the donors and directors. Under such circumstances, the nonprofit could choose to be a pure donative nonprofit. More

concrete, this case corresponds to setting  $x = 0$ , giving  $U = U(z, 0)$ ,  $D = D(z, 0, S)$  and  $C = C(z, 0)$ . Eliminating  $\lambda$  in (4.4) and (4.5) gives:

$$(4.9) \quad U'_z = \frac{(D'_z - C'_z)}{D'_S}$$

Equation (4.9) says that the marginal utility of  $z$  must be equal to the marginal cost from deriving donations from solicitation.

## Forprofit

I assumed that the forprofits are uninterested in engaging the public good provision, if they do not earn any money by doing so. One may argue that the forprofit could receive donations and provide the public good. Nevertheless, we assume that the donors prefer to support nonprofits, possibly due to the fact that nonprofit, unlike forprofit, lack the incentive to provide less public goods than they promise (see subchapter 4.2 for trust-related arguments). Thus, the forprofit will have neither donations nor solicitation costs, i.e.  $D_{FP} = S_{FP} = 0$ . Not surprisingly, we get the standard result (i.e. price equals marginal cost), that is the forprofit adaption condition, when we derive the simplified budget condition, originally given in (4.1):

$$(4.10) \quad p = C'(z, x)$$

with  $z = 0$  if there are no synergy effects in the productions of  $z$  and  $x$ , or if such effects are too small to cover the start-up costs for providing  $z$ . Alternatively, one could have modeled forprofit to attract donations at a higher cost than the nonprofit. In this case, the forprofit would in addition to (4.10) set their marginal donations (i.e. the indirect price of attracting one more unit of the public good) equal to the marginal cost of the public good, and the marginal benefit of solicitation on donations equal to the marginal solicitation cost. As mentioned earlier, this corresponds to the nonprofit solution, where  $D'_x = 0$  and  $U'_x = 0$ , keeping in mind that the level of  $x$  could differ between forprofits and nonprofits for different levels of  $z$ .

## Non-Donative Nonprofits Facing the Competition

I will now turn to the non-donative nonprofits, i.e.  $D = S = 0$ . Given that they survive in the competition against forprofit firms, they will adapt in compliance with (4.7) without donations:

$$(4.11) \quad C'_x = p + \frac{U'_x}{U'_z} C'_z$$

As discussed in the subsection about quantity choice above, whether the nonprofit's marginal costs will be above, below or equal to the price will depend on the sign of  $U'_x$ .

In order for the nonprofit to survive in perfect competition with the forprofit and still provide the public good, it must either have some comparative advantages contra the forprofits or the competition must be limited. Otherwise, it will not be able to finance the provision of the good, which is the only good with a positive impact on their utility. The nonprofit will stop producing, if  $U'_x < 0$ , and be indifferent to producing with price equal to marginal costs, if  $U'_x = 0$ . By earlier assumptions (i.e.  $z > 0$ ), the nonprofit will withdraw from the market.

A possible explanation for how non-donative nonprofits could survive in the competition against forprofits and still provide the public good, is synergies between the productions of  $x$  and  $z$ . A natural objection against this rationale is that forprofit will be able imitate the nonprofit. Nonetheless, we could assume that the nonprofit in question has gained scope advantages, whereas the forprofits are unable to make use of the synergies. Such advantages could stem from past events, such as myopic profit-seeking among the forprofit firms or substantial start-up support from the government or private donors. I will now turn to my own model extension, in which synergies between the productions of  $x$  and  $z$  descends from the labor market, by integrating 'green worker theory' to the model framework.

## Green Workers

As stressed in previous subsections, non-donative nonprofits should have some advantage contra forprofits under competitive conditions in order to be able to provide the public good. One such advantage could stem from the theory of 'green workers' (confer section 6.2.6). According to the theory, workers are willing to accept lower wages than normal, if they perceive their employer as a promoter of the common good (Brekke and Nyborg 2008). In agreement with this theory, I will adopt Frank's (2009) assumption that the workers' wage ( $w(*)$ ) is a decreasing function of the employers' provision of the public good (i.e.  $w'(z) < 0$ ). One could of course argue that forprofits could imitate nonprofits to some extent, in order to attract green workers as well. However, I dismiss this possibility, by assuming that the forprofits are regarded less credible as public good providers, due to their profit incentives.



More concretely, I assume that the labor input, given by  $L(*)$ , is the only input factor of production and increases with the production of the two goods (i.e.  $L'_1(z, x) > 0$  and  $L'_2(z, x) > 0$ ). The cost function becomes:

$$(4.12) \quad C(z, x) = w(z)L(x, z)$$

If the provision of the public good is increased, the marginal costs become:

$$(4.13) \quad C'_z = w'(z)L(x, z) + w(z)L'_2(x, z)$$

The first term on the right hand side is negative and reflects the wage decrease that follows from increased provision of the public good. The second term on the left hand side is positive and reflects the costs associated with hiring an additional worker. Thus, we have two countervailing effect. Even though it is natural to assume that the marginal costs will increase eventually, the worker's preferences for the public good provide the nonprofit an advantage, which enables it to provide the public good.

Inserting for the cost function from equation (4.12) in (4.11) (remembering  $D = S = 0$ ) gives:

$$(4.14) \quad C'_x = p + \frac{U'_x}{U'_z} (w'(z)L(x, z) + w(z)L'_2(x, z))$$

The interesting feature of equation (4.14) is  $w'(z)L(x, z)$ , which reflects how much the nonprofit saves by decreasing the wages through higher provision of the public good. Moreover, the equation says that the marginal willingness to pay for  $z$  in terms of  $x$  must be exactly offset by the marginal cost in production of  $z$ , measured in unities of  $x$ , and adjusted for the wage decrease that follows from an increase in  $z$ .

By inserting the cost function given by equation (4.12) into the forprofits' adaption condition (4.10), we get:

$$(4.15) \quad p = w(0)L'_1(0, x)$$

Since  $w(0) > w(z^*)$ , where  $z^*$  is given by equation (4.14), the nonprofit will be able to meet nonprofits in free competition and at the same time provide the public good; all because of a green worker advantage in the labor market.

## **An Example: The American Knowledge Sector**

A relevant example for a potential dynamic extension of my model is the nonprofit dominance in the American knowledge sector (see for instance Harvard University 2012, Princeton University 2012, Stanford University 2012 and Yale University 2012). Here, education could be viewed as a heterogeneous private good, and research could be considered as a collective good with a positive impact on the education in the long term. The nonprofit universities might prioritize research more than forprofit universities, both because they care more about the research, and because the private universities do not take into account the long term synergy effects between education (a quality adjusted private good) and research (a public good). Here, the nonprofits could gain a comparative advantage, in the sense that a good research environment based on past research could make it less costly for them to attract the best students and researchers, and produce high quality education and research. Thus, nonprofit universities might both be able to have higher fees and lower costs than the forprofit universities. The surplus could be used to cross-subsidize research. It should be noticed that in the instance of universities, donations becomes relevant, particularly private donations.

### **4.1.4 Critique on Weisbrod's Public Good Approach**

Ware is critical to Weisbrod's original model of nonprofit organizations as a solution to the free-rider problem of public goods. He points out that private benefits could be bought directly, rather than indirectly through a contribution. Furthermore, he claims that a 'peer group'-interpretation and a 'warm glow'-interpretation of Weisbrod's argument will be invalid in an environment of rational and selfish actors. He argues that Weisbrod have to change his behavioral assumption for at least some individuals to allow social norms or altruistic preferences. This will however violate Weisbrod's behavioral conduct in form of selfishness and rationality, which were the underlying assumptions of the public problem in the first place. Ware also asserts that Weisbrod's medium voter assumption and tax-argument is a bit crude and simplified, but he realizes that it does not ruin Weisbrod's main arguments (Ware 1989). With more sophisticated assumptions about the public sector's behavior, one may integrate politics dynamic, channels of lobbyism, institutional laws etc.

Next, Ware (1989) stresses that even if the contribution problem for provision purposes are ignored, the goods that nonprofits provide are to a large extent private goods. Weisbrod

(1988) recognizes this problem, suggesting possible distinct models for nonprofits with different ‘degree of collectiveness’. Furthermore, Ware claims that if the ‘free-rider problem’ could be solved, rational individuals would be able to do so within forprofit organizations. Nevertheless, he recognizes that the provision of public goods probably would have been lower without nonprofit organizations, because donors might have more confidence in nonprofits. However, such arguments could not be endogenously derived from Weisbrod’s model framework. Despite of his critique and Weisbrod’s model’s noted limitations, Ware acknowledges Weisbrod’s contribution as a significant to the nonprofit literature, and that it stimulated further development of rational choice models for nonprofits.

In an empirical investigation in 2000 related Johns Hopkins Comparative Nonprofit Sector Project, Anheiner et al. (2000) find that government failure theory (compromising inter alia the public good approach) was unable to explain why the size of the nonprofit sector varies from one place to another. Their dependent variables represent the total size of the nonprofit sector for each country, neglecting the diversities between different subsectors. The authors concluded that the nonprofit sector did not grow proportionally with the demand heterogeneity. However, by applying panel data methods with one-way fixed effects, Matsunaga et al. (2010) find from the same data set that Anheiner et al.’s conclusion may have been drawn too hasty. Using a pooling data set in their estimation, they concluded that Anheiner et al.’s results may suffer from sample problems, specification errors or both. However, Matsunaga et al.’s results fail to explain variations in the nonprofit sector, when they include unpaid voluntary employment as an explanatory variable.

Slivinski (2003) points out that Weisbrod’s explicit equating of provision and financing leave unanswered questions about how public financing of forprofit and nonprofit firms should be considered, and how this kind of provision differ from direct public provision. He highlights that Weisbrod’s rationale for nonprofits is very useful, albeit being a very rough simplification that only considers one public good with a single set of characteristics. Furthermore, he stresses that Weisbrod model is based on a crowding out mechanism from public provision. Although Slivinsky may be of the opinion that the crowding out mechanism most likely will dominate, I interpret him to implicitly indicate that a dominating crowding in mechanism in the market must be countered by a modification of Weisbrod’s model. I will return to discussion of public donations’ crowding in and crowding out mechanisms in my section 7.1.2. See also the voluntary failure approach in subchapter 5.2 for more criticism.

## 4.2 The Trust Approach

In this subchapter, I turn to an approach developed by one of the other pioneers of economic treatment of the so called ‘third sector’, Henry Hansmann. I start out by reviewing Hansmann’s original trust approach in section 4.2.1. Thereafter, I run through a model made by Holtman and Ullmann in section 4.2.3, where nonprofits and forprofits compete in a market characterized by asymmetric information at different qualities. In section 4.2.4, I suggest that the trust approach might be combined with a green consumer approach, integrating insights from green theory. As in previous subchapter, I round off by providing some criticism to the pioneers’ original version of the approach; this time Hansmann’s approach in section 4.2.5.

### 4.2.1 Hansmann’s Trust Approach

In 1980, five years after Burton Weisbrod launched his public good approach, Henry Hansmann (1980)<sup>32</sup> became the first to introduce a theory, where the rationale behind nonprofits was based on trust-arguments. In *The Role of Nonprofit Enterprise*, Hansmann provide a theory, which highlighted how demanders could be confident that a service was produced in the first place and at the right quality level. He referred to these types of goods as ‘trust goods’. In contrary to Weisbrod, who had argued that the rationale for nonprofits lies within government failures in relation to provision of public good, Hansmann promoted ‘contract failure’ in situations with asymmetries or unverifiability as a rationale for nonprofits. Hansmann’s model’s starting point is asymmetric information in the sense that the consumers cannot verify whether a good have been supplied at all, and if it was supplied at sufficient quality or quantity. Such problems could arise; when it is difficult to verify the level or quality of a provision for a court of law; when the consumer is not the same person as the one who pays for the good; and moreover, when one are dealing with certain complex personal services such as education, day care for children and nursing homes.

Hansmann was the one who introduced the non-distribution constraint, which defines nonprofits as organizations prohibited from distributing their surplus (see for instance Ben-

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<sup>32</sup> Hansmann (2003) himself credits Kenneth Arrow, Michael Krashinsky and Richard Nelson for their contributions to his trust approach to nonprofits.

Ner and Gui 2003 or Brody 2003). The condition constitutes an elaboration of an observation done by Arrow in relation to the medical care (Ortmann and Schlesinger 2003) and has been widely adopted by other approaches (see for instance Ben-Ner and Gui 2003 or Brody 2003). Due to their non-distribution constraint, nonprofits supposedly lack the forprofits' incentives for shirking on quality to earn a surplus, which make them more credible as quality providers than forprofits, both from the point of view of consumers and donors. In his transaction cost approach, Hansmann (1996) suggest that nonprofit ownership is optimal, when the conflicts between the costs of market contracting (i.e. contractual costs) and the costs of ownership (i.e. ownership costs) are too strong for efficient individual ownership. The underlying cause could either be extreme asymmetric information between the firm in question and some group of patrons (typically the consumers), or too high costs for exercising efficient control compared to value of the firm's transaction. In short, nonprofit ownership implies abandoning ownership benefits for stricter fiduciary constraints on the management.

One may say that nonprofit organizational status functions as a signal for trust, solving the information problem between consumers and producers. Hansmann (1980) suggests that nonprofit firms provide an imperfect guarantee for the demand side against an exploitation of the asymmetric information from the supply side. The nonprofit organizational form will be chosen for correcting information failures, when it performs better or best together with other devices like government regulation of profit rates, cooperatives and cost-plus contracting. Although Hansmann (2003) consider asymmetric information and trust arguments as important for explaining nonprofit, he underpins that his model should be seen as a partial explanation for nonprofits' existence and not as a unifying approach. He also stresses that the public sector could see nonprofits as the best response to information failures.

#### **4.2.2 Extensions of Hansmann's Trust Approach**

In agreement with Hansmann's theory, Steinberg (2003) suggests that consumers with high searching or compliance costs are willing to pay a higher price for nonprofits' provision, because they are considered more trustworthy in terms of good quality. He refers to studies where this hypothesis is confirmed for nursing homes and children's day care centers. One relevant example could be the sectors of artistic activities, where the non-distribution constraint possibly allows more free expression. I argue that the trust approach may not only be relevant for the consumer markets, where the nonprofit status acts as a 'consumer

protection device'. In my opinion, it may also have predictive power in labor market for complex and creative services, where some of the advanced and inspiring tasks do not generate income per se (confer subchapter 6.2). One instance could be the university sector, where nonprofits give more autonomy to their professor; not letting administrative and teaching duties come at the expense of research. Moreover, I believe Hansmann's 'trust aspect' could provide a rationale for green theory on nonprofits (confer section 4.2.4 on green consumer theory and section 6.2.6 on green worker theory).

Cerulli (2006) extends Hansmann's ownership analysis to include efficiency in the level of transfers at a political level, in addition to costs efficiency. Embracing the transaction aspects of Hansmann's theory, he argues that a high level of transfers at a political level favors public ownership, whereas a lower one favors nonprofit and forprofit ownership. Valentinov (2007a), on the other hand, proposes a distinction between transaction costs related to opportunistic behavior and bounded rationality. The former type relates to the trust aspects highlighted in Hansmann's approach and is commonly embraced by the transaction approaches to nonprofits. The latter type refers to the limitations that follows direct from information shortage and limited abilities to process information among individual resource contributors.

Rose-Ackerman (1996) asserts that the non-distribution constraint not only makes nonprofits more trustworthy when selling goods, but also provides a leeway for generous impulses of donors and expiry of ideological belief. She highlights philanthropic good provision, which could be seen in context of Weisbrod's public good approach. Furthermore, Kingma (2003) explores the similarities and possible integration of Weisbrod's public good approach and Hansmann's trust approach. He points out that both trust and provision of information could be considered as collective goods, and that a nonprofit status could act exactly as a signal of this kind. Anheier (2009) underlines how cost control has become more emphasized in nonprofit trust modeling over the past decade, as opposed to quality securing. While forprofits must use more resources on signaling good quality through commercials, nonprofits are more dependent on their management's reputation. In the next section, I will turn to a simple trust model by Holtmann and Ullmann in Hansmann's spirit. Later on, in section 5.1.5, I will review a combined entrepreneurship and trust model on nonprofits by Glaeser and Shleifer.

### 4.2.3 Holtmann and Ullmann's Trust Model

I will now review Holtmann and Ullmann's (1993) trust model for nursing homes. In the model, the nonprofit sector's existence is based on transaction advantages contra forprofits, in terms of lower costs related to monitoring of and quality under uncertainty. The authors argue that the model has a broader catchment than just nursing homes. Other relevant sectors could be child care, education and health care. The quantity of nursing home services from the nonprofit sector is given by  $Q_{NP}$  with price  $p_{NP}$ , and a known quality set equal to one. Furthermore, the quantity of nursing home services from the forprofit sector is given by  $Q_{FP}$  with  $p_{FP}$  and unknown quality  $E(Q_{FP}) = zQ_{FP}$ , where  $z$  is a random variable with  $E(z) = 1$ . The rationale behind this could be that the profit incentive of forprofit creates uncertainty about which quality the forprofit firms will provide in the next period. More concretely, the forprofits have a profit incentive to shirk on quality, whereas the nonprofits have no such incentive. As a result, nonprofit status could be perceived as sign of high quality among the consumers.

The underlying assumptions of the model are that the consumers are risk averse, and that nonprofit is expected to provide higher quality than forprofits, and therefore can take a higher price. In addition, in order to explain why forprofit may occupy the market alone, one may assume that the discipline associated with forprofit sector's profit motivation is more efficient at the same quality level. Holtmann and Ullmann further assume that a representative consumer with von Neumann-Morgenstern utility maximizes her expected utility function ( $U(Q_{NP}, Q^*)$ ) given a budget constraint ( $B = P_{NP}Q_{NP} + P_{FP}Q_{FP}$ ) with income  $B$  and non-negative quantities. They arrive at the following result:<sup>33</sup>

$$(4.16) \quad \begin{cases} Q_{NP} > 0 \wedge Q_{FP} = 0 \text{ with } \frac{E\left(\frac{\partial U}{\partial Q_{NP}}\right)}{p_{NP}} > \frac{E\left(\frac{\partial U}{\partial Q^*}\right)}{p_{FP}} \\ Q_{NP} > 0 \wedge Q_{FP} > 0 \text{ with } \frac{E\left(\frac{\partial U}{\partial Q_{NP}}\right)}{p_{NP}} = \frac{E\left(\frac{\partial U}{\partial Q^*}\right)}{p_{FP}} \\ Q_{NP} = 0 \wedge Q_{FP} > 0 \text{ with } \frac{E\left(\frac{\partial U}{\partial Q_{NP}}\right)}{p_{NP}} < \frac{E\left(\frac{\partial U}{\partial Q^*}\right)}{p_{FP}} \end{cases}$$

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<sup>33</sup> The solution to Holtmann and Ullmann's maximization problem could easily be derived from the following Kuhn-Tucker problem:  $\max_{Q_{NP}, Q_{FP}} E(U(Q_{NP}, Q^*))$  given  $B = P_{NP}Q_{NP} + P_{FP}Q_{FP}$  with  $Q_{NP} \geq 0$  and  $Q_{FP} \geq 0$ . The first order conditions become  $\frac{\partial \mathcal{L}}{\partial Q_{NP}} = E\left(\frac{\partial U}{\partial Q_{NP}}\right) - \lambda P_{NP} \leq 0$ , ( $= 0$  when  $Q_{NP} > 0$ ),  $\frac{\partial \mathcal{L}}{\partial Q_{FP}} = E\left(\frac{\partial U}{\partial Q^*} z\right) - \lambda P_{FP} \leq 0$ , ( $= 0$  when  $Q_{FP} > 0$ ) and  $\frac{\partial \mathcal{L}}{\partial \lambda} = B - P_{NP}Q_{NP} - P_{FP}Q_{FP} = 0$ , from which equation (4.16) follows.

Equation (4.16) shows that a large price wedge, extensive risk aversion and large uncertainty about the forprofit quality will be in favor nonprofit provision, while absence of these factors will favor forprofit provision. In case of consumer heterogeneity, the consumers that are most likely to choose the nonprofits will be the ones with best information, best monitoring skills, less need for complex services, a lower aversion against loss from opportunistic behavior, less ability to pay and a lower risk aversion. Under such circumstances, nonprofit and forprofit service-providers could coexist. It is worth noting that the price of the nonprofit service will be higher than the price of the forprofit service in coexistence of the provisions; both because higher quality is more expensive to provide, and because the consumers are willing to pay more for higher quality. Moreover, the model formalizes various trust-related reasons for the existence of nonprofits and explains why consumers may prefer one of the sectors. In their related empiric investigation, Holtmann and Ullmann find support for their model (ibid.). The authors assume that nonprofits have higher quality than forprofits, but do not derive this endogenously. In section 5.1.5, I will go through how Glaeser and Shleifer derive the quality feature endogenously, combining the trust approach with the entrepreneurship approach.

#### **4.2.4 Green Consumer Theory**

In my opinion, green consumer theory could have a role to play in the study of nonprofits. The theory encompasses that some ‘green consumers’ have higher willingness to pay for goods that they perceive as corporate social responsible (Lowrey et al. 1995). The missing link here is that nonprofits may appear more corporate social responsible, since they are established in order to promote the common good, rather than earn profit. I believe Hansmann’s argument would be a special case of the green consumer perspective. Analogous to Hansmann’s trust approach, Lowrey et al. (2005) apply information problems as a possible reason for preferring corporate social responsible firms in their green consumer investigation. There could also be other reasons for green consumers, inter alia altruistic features in the preferences or a social glow of giving. Here, trust consideration could act as a rationale for choosing nonprofit provision.

Take for instance a ‘fair trade product’. If I buy a fair trade product, which is more expensive than similar ordinary products, it is not because of the respective company’s legal status. I do it to support the poor workers who contribute to making the products. Yet, if the company is neither a nonprofit nor is authorized by some fair trade association (e.g. Fair Trade



International 2012 or World Fair Trade Organization 2012), I might be skeptical to whether my extra payment actually reaches the less fortunate workers. Moreover, the forprofits' profit motivation may make me fear that they will try taking some of the exceeding payment from fair trade products and put them in their own pockets. Analogously to green consumer theory, there exists a theory on green workers, which I will discuss in section 6.2.6.

#### **4.2.5 Critique on Hansmann's Trust Approach**

I will now turn to the criticism of Hansmann's trust approach. Even though I find the critics relevant, I want to stress that Hansmann is aware of many of the theories weakness and does not consider the trust approach as a sufficient unifying approach for the nonprofit sector alone (Hansmann 2003). Rightfully, I would say, Bacchiega and Borzaga (2003) points out that Hansmann's non-distribution constraint is probably less striking for some third sector actors, particularly in the case of certain commercial foundations, cooperatives and mutuals.

Although finding Hansmann's transaction cost approach transparent, Borzaga et al. (2009) highlight that it fails to explain the dynamics of cooperative firms and social enterprises. In the authors' opinion, Hansmann underestimates the innovative traits in these firms.

Using the non-distribution constraint to define nonprofits, Hansmann excludes parts of the third sector from the 'nonprofit term' (confer Hansmann's categorization of nonprofits, treated in section 2.3.2). Furthermore, Bacchiega and Borzaga argue that the constraint's protection against opportunistic behavior, accompanied by forprofits' disability to establish good reputations is exaggerated. Hansmann (2003) recognizes that his theory is most adequate for donative nonprofits, and that a nonprofit form constitutes a rather rough protection device for consumers. Brody (1996) asserts that the non-distribution constraint as an explanation for nonprofits constitutes a circular argument, in the sense that the public disability to judge quality is solved by nonprofits provision, in which quality cannot be judged. She argues that the internal cost of moral hazard could surpass the external disciplinary gains from not being able to distribute profit directly (confer section 6.1.3).

Ware (1989) describes Hansmann trust contribution to the theory of nonprofits as important. Yet, he has several objections. First, Hansmann assumes that a demander and donors easily could distinguish between goods provided by nonprofit firms and goods provided by forprofit firm. Ware claims that it is far from evident that nonprofits' goods are distinguishable from

forprofit goods, and underpin that many nonprofits' legal status is unknown to the user. Second, although Hansmann stresses that to the extent that nonprofits do not maximize profit, there could still be a contract failure due to governing failures, such as moral hazard and rent-seeking. Third, adopting Ware's point of view, Hansmann's model does not explain the behavior of those who contribute to various nonprofits in the promotion of their operations.

Ware asserts that many donors and consumers would prefer nonprofits to forprofit, even if it was verified that the forprofits were most efficient. He justifies this belief by claiming that certain norms make it socially unacceptable to make profit from the production of particular good or services. Fourth, Ware is doubtful about Hansmann's suggestion that nonprofits constitute the right medium to provide complex personal services. He underpins the importance of lack of benchmarks, when acquiring these kinds of services. Next, he points out that several industries in this category are far from dominated by nonprofits (e.g. car body repair shops). Fifth and finally, Ware opposes the assumption that the quality reputation correspond to the allegedly better quality provided by nonprofits. From my point of view, all of Ware's objections are relevant for why nonprofit may not be the best solution to a trust-problem, but that is not to say that these offsetting effects have to be dominating.

By the same token as Ware, Ortmann and Schlesinger (2003) argue that three conditions must be satisfied by the approach in order for the trust hypothesis to be valid. First, it must cope with the challenges with the interior incentive structure, deriving from the absence of a manager or owner that can distribute profit ('incentive compatibility challenge'). Second, nonprofit must not be adulterated by intruders that want to take advantage of the perceived trustworthiness ('adulteration challenge'). Third and last, the nonprofit status may signal reliability, when the behavior of forprofits is not reliable ('reputational ubiquity challenge'). After reviewing the empirical literature on commercial nonprofits within day care, health care, education and elderly care, Ortmann and Schlesinger question whether these conditions are satisfied. They conclude that the trust hypothesis stands on shaky grounds as a general proposition. Hansmann (2003) counters Ortmann and Schlesinger's critique, claiming that they are too dismissive about trust impact in donative nonprofits and interpret the trust hypothesis too strict for commercial nonprofits. He maintains that the importance of nonprofits in markets characterized by asymmetric information and underpins that trust arguments only should be considered as one of the explanations for nonprofits.

## **4.3 The Stakeholder Approach**

In the previous sections, we have discussed probably the two most influential demand approaches to nonprofit theory so far; one might even say the most common approaches to nonprofits in general. In this section, I will run through a newer demand approach in the nonprofit literature, namely the stakeholder approach. To a larger extent than the two previous approaches, the stakeholder approach, highlighted in this subchapter, also takes in insights from the supply side. Nonetheless, its core focus still lies on the demand side. A short introduction to stakeholder theory is given in section 4.3.1. Next, I will go through the stakeholder approach by Ben-Ner, Gui and Van Hoomissen in section 4.3.2. I end the subchapter and my treatment of the demand approaches moreover, by giving some criticism on the stakeholder approach in section 4.3.3.

### **4.3.1 Introduction to Stakeholder Theory**

A stakeholder in an organization is a party that can influence or be influenced by it. In general, different stakeholders have different and partly conflicting interests. Note that there is nothing surprising by this conflict; every transaction made is based on a fundamental conflict of interest, and every organization is subject to several transactions. Stakeholder theory involves both internal and external stakeholders, so even though the demand side often gets much attention, it is not a pure demand side theory (Krashinsky 2003).

Reflecting on the rest of the nonprofit literature in light of coinciding and conflicting interests between stakeholders provide one way to organize the existing theory. Krashinsky points out that the assumption about competition ensuring efficiency within forprofit organizations is likely to be violated under imperfect competition. Therefore, different forms of nonprofits may well be the best answer to the problem in front in several instances. Krashinsky sees both Weisbrod's public good approach and Hansmann's trust approach, as well as many other approaches, as consistent with the stakeholder theory, albeit as partial approaches (ibid.).

### **4.3.2 Ben-Ner, Gui and Van Hoomissen's Stakeholder Approach**

During the 1990s, Ben-Ner started to adapt the stakeholder approach to nonprofit organizations in several articles with various co-authors, including Benedetto Gui and Van

Hoomissen (Ben-Ner and Gui 2003, Krashinsky 2003). Ben-Ner and Gui (2003) describe the supply of nonprofits as a derivative of the restrained demand for this organizational form. An entrepreneur formulates a project and convinces some donors to cooperate by enabling supply by donations. Thereafter, relative efficient governance is ensured through self-selection of managers, volunteer contributions within the organization and care for each other in case of mutual nonprofits (confer section 2.3.2). We will treat these organizational matters further in context of the traditional theory of the firm in subchapter 6.1 and in light of insights from behavioral economics in subchapter 6.2. Ben-Ner and Gui represent seven rationales for nonprofits to exist out of the stakeholders' interests, depending governing failure and market failure in connection with the organization or the stakeholders.

First, organizations could have an informational advantage over its consumers or suppliers, regarding some characteristics of a transaction, obviously to the stakeholders' disadvantage. Second, monopolies could charge too high prices and too low quality from the stakeholders' perspective, whereas the opposite holds for monopsonies. Third, some firms tend to discriminate systematically against some stakeholders grounded in characteristics irrespective of productivity such as background, gender and race. In all these three cases, a shift from forprofits to nonprofits entails both increased efficiency and redistribution in favor of the beneficiary stakeholder. Fourth, hidden characteristics among beneficiaries could create problems like adverse selection. Ben-Ner and Gui recognize that a 'nonprofit status' does not eliminate such challenges. Yet, they assert that a 'non cooperative' solution could diminish these challenges through a more transparent monitoring in between the beneficiaries (ibid.).

Fifth, public goods provide a two-sided information problem, where both parties could be expected to misbehave. A forprofit would want to collect as many contributions as possible to some minimum quantity and quality, whereas stakeholders are only kept from free-riding by fear that their opportunism will lead to no provision, which is unlikely to happen in instance of many contributions.<sup>34</sup> Furthermore, stakeholders may fear future abuse of revealed preferences by using it for profit purposes or to obtain future market power. Another problem in this regard is that the signs of 'marginal impact monitoring' for both quality and quantity,

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<sup>34</sup> The authors ignore the discussion about the effects of the expected significance of contribution and the income effects for small amounts of contributions. Yet, these effects are likely to be of less importance. First, a nonprofit will probably go bankrupt, if there are too few contributions. Second, the discussion of income effect from a game theoretical perspective will first and foremost be of relevance, if we are in an unstable Nash equilibrium, while the authors' primer interest lies with in this case; as far as I understand them; is to describe a stable situation.

which are not necessary positive, and if expected positive, the magnitudes are still unknown. A nonprofit's 'non-distribution constraint' could make these organizations be less tempted to shirk on quality and quantity provided; thus making them more credible as quality providers. However, non-participating stakeholders must still rely on controlling stakeholders, implying that the hidden information problems could remain largely unsolved; especially for bigger firms. Hence, additional control mechanisms may be needed (ibid.).

Sixth, the authors enhance another two-sided information problem, namely excludable goods. The problems concerning free-riding, marginal-impact monitoring and provider selection are smaller than for excludable goods. Nevertheless, the quality or variety dimension, as well as efficient pricing of admission, could still cause problems both on the provision side and on the external stakeholder side in terms revelation of preferences. Again, voluntary contribution and purchases could be limited by exploitation of revealed preferences. Nonprofit may offer a partial solution to the problem in form of direct control mechanisms that makes the beneficiaries reveal their preferences, without having to fear being abused (ibid.).

Seventh and last, the authors highlight so called 'relation goods'. The term refers to the fact that a significant amount of people's utility and motivation stems from relations, which are seldom treated by economic theory. The term 'relation goods' have been a research topic of Benedetto Gui since the late 1980s. The authors argue that nonprofits have three comparative advantages over forprofits. First, they are more suited for creating favorable environment for social interactions. Second, they are more able to host satisfactory personal relationships for ultimate control over the organization. Third and last, they easier facilitate a sense of belonging and thereby a good environment for coordination (ibid.). Bacchiega and Borzaga (2003) argue that non-verifiability is particularly important for services with a relational component and quality component. In addition to the 'nonprofit correcting devices', Ben-Ner and Gui (2003) mention other protective mechanisms that are available for the forprofit too, including the sellers' performance based reputation, public or self-regulation of the industry, independent monitory agencies, professional ethics and more.

Analogously to Weisbrod's original public good approach, Ben-Ner and Van Hoomissen (1991) argue that nonprofits will occur, when there is a sufficiently large group of stakeholders with common preferences deviating from the median political interest. Ben-Ner and Benedetto Gui (2003) suggest that government agencies and nonprofit organizations could be seen as two different solutions to a scenario, where either the conditions for perfect

competition are violated or the good in question is not completely private (i.e. it is not fully excludable or rival). According to the Ben-Ner and Gui, nonprofit organizations may outcompete forprofit organizations, by acting as a governing or market failure correcting devices, in the sense that they limit these failures. Although this constraint can prevent undesirable behaviors, it is almost ineffective in enforcing desirable behaviors.

### **4.3.3 Critique on the Stakeholder Approach**

In order to deal with issues related to internal moral hazard and rent-seeking, Ben-Ner suggests legal reforms; let us refer them jointly as the interior disciplinary constraints. This constraint could empower demand-side stakeholders by appointing them as members in a legal sense with some control ability. It is exactly at this point, Krashinsky (1986) claims it is a flaw in stakeholder theory of Ben-Ner, Gui and Van Hoomissen. The problem arises from the non-distribution constraint and the interior disciplinary constraints. The paradox Krashinsky highlights is that if consumers could judge precisely on the production and shop around between different producers, the opportunistic behavior would albeit disappear, but so would the justification for the nonprofit sector. Membership control requires that the members have sufficient information to inspect potential shirkers and prosecute the ones that do not behave.

Similarly, lack of the profit incentives may prevent nonprofits from exploiting stakeholders' trust, but its absence of profit incentives could also lead to more shirking and a larger bureaucracy. Furthermore, although not driven by profit motives, the managers of nonprofits may still have deviating preferences from the stakeholders, when it comes to quality and quantity of various good. Therefore, the managers could through cross-subsidization implement a different set of prices, qualities and quantities than the one the consumers and donors would prefer. Moreover, Krashinsky finds the stakeholder approach on nonprofit organizations both lucid and useful for surveying the nonprofit literature, but he highlights that one should be aware of the limits of the approach. When concluding, he points out that the focus on stakeholders undermines the notions of mutuality, fairness and common interests, which could be important features for explaining the nonprofit sector (ibid.).

Personally, I share Krashinsky's concern about the neglect of interior organizational matters. My impression is that this is the case for most of the attempts to unify nonprofit theory.

DiMaggio (2003) asserts that it remains blurry who is considered as ‘insiders’ and who is considered as ‘outsiders’, in nonprofits in the stakeholder approach. What is more, Caers et al. (2011) address this issue, trying to integrate stakeholder with principal-agent theory and stewardships theory, both in case of internal and external stakeholders. They identify the nonprofits’ ‘missing principals’ from the agency theory, by using the stakeholder perspective. In line with stewardship theory, they point out the agents often will have coinciding interests with the principals. In relation to the evaluation of the stakeholder approach, Caers et al. classify employees, managers and operational volunteers as internal stakeholders, and competitors, customers, organizational partners and suppliers as external stakeholders. They categorize the board of directors as an intermediate group with connection to both the surrounding environment and the organization itself. The categorization of the board is obviously a complex matter, seeing that it is composed of members from the other groups.

Ben-Ner and Gui (2003) argue that nonprofits could be a response to government failure, but do not choose to draw further attention to this matter. More generally, they put little emphasis on the role of the public sector. Ware (1989) does however points out that nonprofits could have an advantage compared to the state, when it comes to information and cost of coordinate and implement actions due smaller bureaucracies and possibly voluntary contributions. Ben-Ner and Gui (2003) also stress that the chosen politicians do not always reflect the beneficiaries’ wishes. Nonprofits could focus on the efficiency in terms of compliance between the beneficiaries’ marginal benefit and marginal cost of production, without having to focus on political compromises.

I will discuss the problems regarding incentive structure in nonprofits in section 6.1 and immerse my self further into these problems, taking behavioral factors into account, in section 6.2. I believe some of the other of Krashinsky’s objections could be view as contradictory mechanisms for preferring nonprofits for provision of a given good, rather than an objection to the stakeholder theory as a whole. Moreover, it should be noted that many of Krashinsky’s objections against stakeholder theory are just as valid towards many of the other approaches, which attempt to unify nonprofit theory.

## 5 Theory of Supply for Nonprofits

In this chapter, I will run through three supply approaches for nonprofits. Analogously to the demand approaches, those regarding supply have important insights from the other side of the market. Yet, they are commonly referred to as supply side theories, as their starting point and core focus lies on the supply side of nonprofits. I begin with the entrepreneurship approach in subchapter 5.1, which follows the conducts of institutional economics and highlights institutional choice. Next, I will discuss the voluntary failure approach in subchapter 5.2, which treats the third sector as the initial supplier of public goods. At last, I will put emphasis on the organizational behavioral approach in subchapter 5.3; an approach that retrieves insights from evolutionary economics. In addition to these three approaches, the social origin approach, briefly discussed in chapter 3, could be considered as a supply approach. Besides, the discussion in chapter 6 about interior supply factors and processes of nonprofits, such as moral hazard and intrinsic motivation, is sometimes referred to as the property right approach.

### 5.1 The Entrepreneurship Approach to Nonprofits

This subchapter, I devote to the entrepreneurship approach to nonprofits. I begin by taking a quick look at nonprofit entrepreneurial history in section 5.1.1, before I draw attention to what I refer to as the paradox of nonprofit entrepreneurship in section 5.1.2. I then review some basic perceptions from the general entrepreneurial literature in section 5.1.3. Next, I address the entrepreneurial theory for nonprofits in section 5.1.4. Further on, I render a formal model of nonprofit entrepreneurship by Glaeser and Shleifer in section 5.1.5. At last, I provide some criticism of the approach in section 5.1.6.

#### 5.1.1 A Glimpse of the History of Nonprofit Entrepreneurship

As for most organizations, entrepreneurship plays a crucial role in the establishment of nonprofits. Admittedly, some nonprofits are instead based on testaments. For instance, The Nobel Foundation (2012) was established in 1900 on the basis of Alfred Nobel's will. Still, many, if not most nonprofit firms, are set up by entrepreneurs. The Red Cross, for instance, was founded by the Swiss Jean-Henri Dunant and four others in 1864, after Dunant had witnessed the bloody battle of Solferino in the Second Italian War of Independence



(International Red Cross and Red Crescent Movement 2012). Nonprofit entrepreneurs may often be private or government organizations themselves (DiMaggio 2003). For instance, different Red Cross societies founded the International Red Cross and Red Crescent Movement in Paris in 1919 (International Red Cross and Red Crescent Movement 2012). In Denmark, Carlsberg Foundation was set up by Jacob Christian Jacobsen in 1876 as a nonprofit for culture and research (Carlsberg Group 2012a). The foundation still owns a majority share of 51 percent in Carlsberg Group (2012b), which currently ranks as the fourth biggest brewer in the world.

### 5.1.2 The Paradox of Nonprofit Entrepreneurship

The existence of self-owning nonprofits seems to be inconsistent with neoclassic theory and the corresponding rationality hypothesis of *Homo Oeconomicus*. Firstly, their establishments imply that a person or a group give up a fortune for a given purpose that most often is not related to the donor's gain. No selfish and rational actor would do so, without expecting a gain. If the donation was done while the donor was still alive, she should rather have used it to her own joy. If the donation on the other hand occurred after the donor's death, the donor should have smoothed her consumption over her lifetime instead. In absence of satiation, it is hard to see that extreme risk aversion combined with uncertainty related to lifespan could justify the establishment of nonprofits through testaments.

In a broader interpretation of the term *good*, the donor might consider the donation and the respective attention as a good by itself. A person may leave some savings for a possible longer lifespan after expected death as insurance. I will however argue that such explanations for establishment of foundations are incomplete and in some cases also speculative.

Nevertheless, it should be noted that the rationality hypothesis of *Homo Oeconomicus* could help to explain why the number of nonprofits are limited. The topic of establishment of nonprofits will not be the main topic of this thesis, but I believe it could serve as an important reference point.

In his non-distribution constraint, Hansmann (1980) highlights that most nonprofits have a barrier from distributing any profits it earns to the person who exercise control over them. Yet, if profit can not be the motive for establishing nonprofits, there must be some other rationale for it – the same goes for preventing distribution of profits. Richard Steinberg (2003,

page 282) remarks that ‘without founding entrepreneurs and those managers and board members willing to play a continuing role in the evolution of the organization, the nonprofit share will obviously fall to zero’. I believe ‘the paradox of nonprofit entrepreneurship’ is a suitable designation for the apparent conflict between neoclassic theory and the phenomenon of nonprofit entrepreneurship. I will address this paradox in the sections to come.

### **5.1.3 General Theory of Entrepreneurship**

The entrepreneurship concept was developed by Joseph Schumpeter in the 1930s. He defines development as a process of ‘carrying out new combinations’ in the process of production. Schumpeter’s concept ‘new combinations’ involves five cases, more precisely; introduction of a new good or a new quality of a good; introduction of a new production method with the same production factor as before; the opening of a new market; adaption of a new factor in production; and carrying out of a new organization in any industry. The ones who take the initiative and carry out the innovative ‘new combinations’ of production methods, are called ‘entrepreneurs’. These need not be the same persons as the investors, managers or owners. In more recent literature, Peter Ducker highlights the leadership and personal development among the nonprofits’ entrepreneurs and managers, which he typically finds to be innovative (Badelt 2003) (see section 6.2.5 for literature on transformational management).

### **5.1.4 Entrepreneurship Theory and Nonprofit Organizations**

The combination of entrepreneurship theory and the paradox of nonprofit entrepreneurship have given rise to an approach to nonprofits, commonly known as the entrepreneurship approach. The approach is supply-based in the sense that its rationale for nonprofits lies in the preferences of nonprofit suppliers (Badelt 2003). While other supply theories typically identify static motivation for nonprofit supply, the entrepreneurship asserts the dynamic dimension of innovation and reorganizing (Young 2003). In addition to provide a market theory of the nonprofit sector and a theory about establishment of nonprofits, recent literature does also emphasize qualitative insights on the practical management and degree of professionalism in a given firm (ibid.).

A main feature in the entrepreneurship approach is the ‘institutional choice’ that the entrepreneur faces, when founding a new organization. Hence, the approach to nonprofits

could be placed in the institutional theory tradition. It is also inspired by other social and humanistic sciences than economics. Although focusing on the supply side, the theory is consistent with approaches dominated by demand arguments, such as Ben-Ner's stakeholder approach, Hansmann's trust approach<sup>35</sup> and Weisbord's public good approach. Recent entrepreneurship theories about the nonprofit sector do not only address the existence of nonprofits, but also attempt to describe the institutional dynamics (Badelt 2003).

One of the seminal contributors to the entrepreneurship approach to nonprofits is Dennis Young, who developed the approach in the 1980s. According to Badelt, Young interprets the nonprofit sector growth in the American economy as an indicator of the extensive entrepreneurship in the nonprofit sector (Badelt 2003) (see subchapter 5.1 for further discussion on this tendency). Young (2003) poses that nonprofit entrepreneurial theories may have some predictive power in terms of qualities and types of services produced by nonprofits. The theory suggests that entrepreneurship is an instinct element of nonprofits; not to say that nonprofits necessarily are more innovative than forprofit firms. Some empirical evidences suggest that nonprofits are particularly innovative or have overcome severe problems. Ironically, the studies of nonprofits entrepreneurship appears to have given nonprofits a better image in form of efficiency in Western countries (see for instance Anheier 2009, Badelt 2003, Geller et al. 2010, Young 2003)

Young distinguishes between various different entrepreneurial types, inter alia 'believers', 'conservers', controllers', 'players', 'power seekers', 'professionals' and 'searchers'. Each type's objective function depends on the corresponding personal characteristics, which goes beyond the monetary preferences. Personal motivation could both be grounded on process oriented factors (e.g. need for independence and personal development) and more outcome-oriented motives (e.g. pride for creative accomplishments and search for power) (Badelt 2003) (see subchapter 6.2 for more on behavioral factors).

Whereas appliance of neoclassic theory would make one conclude that nonprofit firms are something inefficient, which does not maximize profit, the nonprofit entrepreneurship theorists reject this view. Instead, they highlight that socially beneficial objectives in line with the non-distribution constraint could be the motivation behind the entrepreneurship.

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<sup>35</sup> Hansmann has also contributed to the entrepreneurship approach, but is most known for his 'trust approach' on nonprofit theory within the third sector literature (Young 2003).

According to Young (2003), entrepreneurship should not be viewed as a mainly commercial process, but rather as a broader generic evolution. The Schumpeterian entrepreneur's five types of innovations have been widely adopted by nonprofit theorists, when explaining the choice of organizational form. This is particularly the case for the type that involves a new combination of production factors (Badelt 2003).

Both Hansmann and Young embrace the concepts of screening and selection to explain why profit-seeking entrepreneurs may self-select to the forprofit sector, while idealistic entrepreneurs might self-select to the nonprofit sector (Young 2003). In Badelt's (2003) opinion, a clear strength of the entrepreneurship approach is that it provides other entrepreneurial motives for nonprofit entrepreneurs than pure profit maximization. He poses that the entrepreneurial experience provides a mutual learning potential between forprofit and nonprofit, capital formation, establishing of partnerships and risk-taking.

### **5.1.5 Glaeser and Shleifer's Trust-Entrepreneurship Model**

In this section we will condense some insights from the trust-entrepreneurship model of Glaeser and Shleifer (2001), where entrepreneurs could choose to go either forprofit or nonprofit. Choosing to go forprofit will be driven by a wish to earn profit, which for instance could be used for future consumption. If an entrepreneur wants to commit to soft incentives (i.e. incentives that protect consumers, donors, employers and volunteers), she could do so by establishing a nonprofit firm. According to the authors, the establishment could be completely selfish, if the entrepreneur believes that a nonprofit would be the best way to achieve her egoistic aims. The trust feature comes into play through the consumers' inability to verify the quality or observe the quality ex ante.

#### **Model Framework**

In my rendering of Glaeser and Shleifer's model, I will focus less on the donation part and more on the quality aspects. The technology is assumed to be homogenous across firms, but the entrepreneurs of the nonprofit cannot withdraw profits to large extent. Moreover, they have altruistic preferences providing higher quality to the consumers. The quality level is non-verifiable, and thus non-contractible, and it is chosen by the entrepreneur after sale. A low quality choice would imply a non-monetary cost for the entrepreneur, possibly grounded by

altruistic preferences or a worsening in reputation among consumers, workers and possible donors.

Furthermore, the model assumes that exact quality is unknown for the consumer beforehand. The ex post expropriation hurts buyers, employees or potential donors. This affects the entrepreneur through lower financial returns and a non-financial cost mentioned above. The nonprofits will have softer incentives and cut the ex post expropriation, because a nonprofit status reduces the financial returns. The entrepreneurs will choose a nonprofit status rather than forprofit status, if the benefit of committing to high quality is higher the potential benefit of making profits, and vice versa. Since the expected quality is higher for nonprofits than forprofits, the consumers will be willing to pay a higher price for the nonprofit good, when the goods coexist.

Let the organization type be represented by a dummy,  $N \in \{0,1\}$ , which take the value 1 for a nonprofit and the value 0 for a forprofit. While forprofits realize their surplus as profits, the best nonprofits can do is to spend their surplus perquisites. These perquisites have less perceived value than the monetary value. To sum up, the time lapse will be as follows:

- $t = 0$ : The entrepreneur decides whether she wants to establish a forprofit or a nonprofit, i.e. whether she prefer  $N = 0$  or  $N = 1$ .
- $t = 1$ : The entrepreneur presells exactly one unit of a good for a price,  $P$ ; i.e. the sale is discrete.
- $t = 2$ : The firm produces and delivers the presold good of non-verifiable quality,  $q$ , where ‘non-verifiability’ implies that the consumers cannot complain about possible inferior quality.<sup>36</sup>

What is more, we let profit be given by  $\pi$ .<sup>37</sup> Type  $N$ ’s valuation profits,  $V_N$ , are given by:

$$(5.1) \quad V_N = v_N \pi(q) = v(P - c(q))$$

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<sup>36</sup> The key point here is that the quality involves a non-verifiable, or possibly a non-observable, component. There might well be a verifiable and observable component.

<sup>37</sup> Glaser and Shleifer assume that the profit is positive, when the consumers anticipate the benchmark quality, i.e.  $\pi(q^*) = z - c(q^*) > 0$ , applying (5.6) underneath.

where  $c(*)$  represents the costs as a function of quality with  $c'(q) > 0$  and  $c''(q) > 0$ ,<sup>38</sup> and  $v_N$  is a proportional valuation factor for nonprofit's perquisites. For forprofits, this parameter will obviously have full monetary valuation (i.e.  $v_0 = 1$ ), whereas the nonprofits valuation of perquisites will be lower than their monetary value (i.e.  $0 < v_1 < 1$ ). We recall that the sale is discrete; here in the sense that either null or one units are sold.

Glaeser and Shleifer further assume that the entrepreneur of every firm bears a perceived cost of shirking on quality:

$$(5.2) \quad S(q_N) = b(q^* - q_N)$$

where  $b$  is the marginal shirking cost of aberrant quality. The non-monetary cost of shirking on quality is defined as a linear function of the quality discrepancy. The burden of aberrant quality becomes negative, when the realized quality exceeds the benchmark quality, meaning that a realized quality above the benchmark gives a utility gain *ceteris paribus* (ibid.).

### Deriving the Entrepreneurs' Adaption

In Glaeser and Shleifer's model, the entrepreneur's adaption will be a tradeoff between profits or perquisites on the one hand (confer equation (5.1)) and quality provision on the other hand (confer equation (5.2)). Mathematically, each entrepreneur maximizes a quasi-linear utility function based on distributed profits, perquisites and the non-cash costs:

$$(5.3) \quad \max_q U_N(q) = \max_q V(q) - S(q) = v(P - c(q)) - b(q^* - q)$$

The first-order condition becomes:

$$(5.4) \quad b = v_N c'(q)$$

saying that perceived marginal shirking cost of aberrant quality and marginal production cost should be equal in optimum. We recall that  $v_0 = 1$  and  $0 < v_1 < 1$ . The optimal quality for a firm of type  $N$  will thus be:

$$(5.5) \quad q_N = q_N \left( \frac{b}{v} \right)$$

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<sup>38</sup> At one point, Glaeser and Shleifer write that the cost function is concave, but it is clear from the circumstances and text elsewhere that the cost function is convex.

meaning that the marginal shirking cost, after a downward value adjustment for nonprofits due to restrictions in spending, should be equal to the marginal cost.

We see from equation (5.4) that  $c'(q_0) < c'(q_1)$ , i.e. the marginal shirking cost is higher for the nonprofit firm. Under the standard assumption of a convex cost function, the non-verifiable quality will consequently be higher for nonprofit firms than for a forprofit firms (ibid.).<sup>39</sup>

### Condition for Choosing a Nonprofit Status

We will now take a look at under which circumstances, nonprofit status will be chosen by the entrepreneurs.

Glaeser and Shleifer assume that type  $N$ 's inverse demand function,  $P_N$ , is given by:

$$(5.6) \quad P_N = z - m(q^* - q_N^E)$$

where  $q^*$  is the benchmark quality,  $q_N^E$  is the consumers expected quality for type  $N$  and  $z$  is the prevailing price, when the expected quality equals the benchmark quality. What is more,  $m$  represent the demand sensibility of a quality change in a linear manner. Thus, the representative consumer's absolute risk aversion is constant.

Returning to the time lapse, the entrepreneur will choose to go nonprofit at  $t = 0$ , if this gives her a higher utility in optimum, that is if:

$$(5.7) \quad U_1(q_1) \geq U_0(q_0)$$

The left hand side of equation (5.7) represents the benefit the entrepreneur would achieve by going nonprofit, while the right hand side represents the forprofit gain. If this inequality holds, the entrepreneur would accordingly favor nonprofit status. The entrepreneur would be indifferent, when the two utility levels are the same.

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<sup>39</sup> Mathematically: If  $c''(q_i) > 0$  for  $i \in \{0,1\}$  and  $c'(q_0) < c'(q_1)$ , then we must have  $q_0 < q_1$ .

Let us now take a look at how large demand sensibility that is needed to ensure that the entrepreneur choose to go nonprofit; we call this level  $m^*$ . After some running calculations,<sup>40</sup> we isolate  $m^*$  on left hand side and structure the terms on right hand side and obtain:<sup>41</sup>

$$(5.8) \quad m^* = \frac{(1-v)z - (c(q_0) - vc(q_1)) - b(q_1 - q_0)}{(1-v)q^* + vq_1 - q_0}$$

We see that the demand flexibility in case of indifference must be exactly offset by total valuation gap between the forprofit and the nonprofit, relative to the differences in valuations of the quality gaps, where total valuation gap could be decomposed to the valuation gap of prevailing price, the valuation gap in cost differences and the gap between the perceived costs of shirking quality. In short, the demand flexibility of quality is equal the relative valuation of nonprofit quality supply, when entrepreneurs are indifferent between forprofit and nonprofit status.

Note that since  $q_0 < q_1$ , the entrepreneur gains a higher price if she chooses nonprofit status, in addition to avoiding the perceived cost of shirking on quality. Moreover, they choose a nonprofit status when  $m^* \gtrsim m$ . We keep in mind that the perceived cost of shirking quality for a nonprofit is negative, meaning that the quality realized by nonprofits is higher than the quality benchmark, such that there is an excessive gain, rather than a shirking cost (ibid.).

## Comparative Statistics

A key insight from equation (5.8) is that whether markets with non-contractible quality are dominated by nonprofits or forprofits depends on how the consumers value quality. High valuation of quality softens profit incentives, implements higher ex ante prices and thereby makes the ability to commit more valuable. Another important lesson is that altruistic preferences with respect to quality among entrepreneurs most often suggest nonprofit status. Note that expected quality (assumed equal to the realized quality) here relates to the status of

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<sup>40</sup> Inserting for (5.1), (5.2) and (5.6) in (5.7) yields:

$$\begin{aligned} & v(z - m(q^* - q_1) - c(q_1)) - b(q^* - q_1) \\ & \gtrsim z - m(q^* - q_0) - c(q_0) - b(q^* - q_0) \end{aligned}$$

Assuming that the equation holds by equality and solving for  $m = m^*$  gives (5.8).

<sup>41</sup> Note that there is a typo in the equivalent solution in Glaseser and Shleifer's solution. There should be a positive sign in front of the term  $vc(q_1)$  in the numerator, not a negative as the authors suggest.



the firm, and that dividends from the firm can not be used to increase quality. Thus, we have ruled out the existence of the prevailing effect where an entrepreneur, generally known for her altruistic attitude and appreciation of high quality, choose a forprofit status in order to derive more profits for altruistic purposes.

Two other crucial points regard the attractiveness of perquisites. First, high net revenue makes forprofit relatively more attractive, because there is a valuation loss related to spending the surplus on perquisites rather than dividends (keeping in mind that  $0 < v < 1$ ). Second, if forprofit status yields a positive utility for the entrepreneur, a low valuation of perquisites (i.e. a low  $v$ ) would imply that forprofit dominates the market, vice versa. In the instance of heterogeneity among infant firms, those with lower costs would choose forprofits, and those with higher costs would go nonprofit. Combining these insights, it is clear that a very profitable firm with only trivial perquisites seems unlikely to be a nonprofit (ibid.).

## Discussion

In the case of homogenous technologies, equation (5.7) will typically hold in inequality. If the right hand side is largest, nonprofits will dominate (e.g. child care), whereas the forprofit will dominate if the left hand side is largest (e.g. automobile manufactures). Heterogeneity in the utility function of entrepreneurs and consumers could explain why both firms exist in some industries (e.g. health care). Coexistence could in addition stem from heterogeneity in employment relationships, where nonprofits request more of their workers than forprofits (e.g. theatres). Alternatively, heterogeneity in the consumers' ability to monitor could justify coexistence of both sectors. Nonprofit status may also signal that the entrepreneur cares more about the quality than monetary gain.

Glaeser and Shleifer mention other ways that soften incentives than a nonprofit status. Entrepreneurs with a known and little taste for or limited access to perquisites may act effectively as managers of nonprofits. Another possibility is a governing board that is unable or uninterested in receiving perquisites (confer section 6.1.4 about control mechanisms). Besides, quality could be protected by a sufficiently good reputation and ex post competition. The former feature is captured by the model, while competition could reduce risk, if there is ex post appropriation for forprofits, and thereby the need for nonprofits. Without such competition, however, nonprofits' role comes essential. As an example, the authors mention

the protection against universities' exploitation of their research staffs' investment in human capital.

The authors show that donations based on altruistic or social glow motivations easily could be incorporated to their model. They find that quality increases in the level of donations, whereas donations rise with tax rate and decline one-for-one as the firm obtains alternative sources of income. (I refer to subchapter 7.1 for further discussion on these sources.) Soft incentives make nonprofits more trustable than forprofit for donors, possibly accompanied by tax advantages. This is consistent, but yet different from much other economic literature on donations, which focuses on public good provision. Rather than building their model on Weisbrod's public good approach, like many earlier nonprofit entrepreneur modelers (confer subchapter 4.1), Glaeser and Shleifer build rationale for nonprofits on insights from Hansmann's trust approach (confer subchapter 4.2) and perceived shirking cost arguments (confer chapter 6.2).

Glaeser and Shleifer's model accentuates the possibility of lower quality than expected after purchase, as a rationale for nonprofits. The authors state that the model exemplifies consumer expropriation under asymmetric information. Although the perceived costs of shirking could stem from non-behavioral mechanisms (e.g. legal arrangements), I consider a behavioral motivation as an applicable interpretation. Glaeser and Shleifer highlight altruism and public spiritedness as a second motivation for nonprofit entrepreneurs. In addition, they provide two more reasons for nonprofits' existence. First, the activity could be unprofitable and rely on charitable donations. Second, switching costs could make it costly for consumers and workers to switch between organizations. Moreover, higher levels of perquisites (e.g. better working conditions, higher wages and more fringe goods) are expected in nonprofit firms. Glaeser and Shleifer highlight donations as perhaps the most important mechanism of nonprofit survival, due to the lack of market mechanisms that support donations to forprofit firms (ibid.). They do not provide a further discussion on non-donative firms or discuss donations to forprofits; for instance in the form of volunteer labor in forprofit hospitals.

### **5.1.6 Criticism of the Entrepreneurship Approach to Nonprofits**

The entrepreneurship approach to nonprofit theory endorses the established nonprofits' comparative advantage over private firms with entrepreneurs' preferences as a baseline. Yet,

Badelt (2003) points out that the innovative power of some nonprofits could be questioned in light of the bureaucratic behavior of large and well established welfare organizations. He also questions whether it is rightfully to say that nonprofits mainly are different from forprofits out of entrepreneurial reasons. I have not succeeded in finding any nonprofit models on entry deterrence or exits, although change in organizational form has been discussed by some authors (see for instance Galaskiewicz and Bielefeld 2003 or Steinberg 2003). Steinberg (2003) remarks that he is unfamiliar with studies on nonprofits preventing market intrusion or conducting technology races. Eckel and Steinberg (2009) integrate transformers of organizations to Young's entrepreneurship approach. They encourage future researchers to model the evolution of missions based on the changes in political power between different stakeholders.

Empirics suggest that the innovational power of nonprofits will vary through its life cycle; a variation that is not captured by the entrepreneurship approach. From Steinberg's point of view, much research has drawn attention to empirical motivations, but far too little on the distribution of the entrepreneurial types (*ibid.*). Badelt (2003) problematizes that entrepreneurial motives usually are hard to observe and formalize, making good empirical studies challenging. Furthermore, although highlighting entrepreneurship, he finds that the approach lacks explanatory power for whether innovative behavior is caused by entrepreneurship, undersupply of some goods or other factors. Consequently, it becomes difficult to test whether the entrepreneurship approach has more prediction power than other approaches on innovational behavior (*ibid.*).

I believe an answer to Badelt's objection would be to combine the entrepreneurship approach with one of the demand approaches, rather than considering it as a universal theory alone. This is exactly what Glaeser and Shleifer (2001) did, when they integrated Hansmann's trust approach. Even though a lucid and relevant theory, I agree that it is a bit too shallow to stand alone as a successful unifying approach. Especially, I miss explanations for the internal dynamic in the organization. Furthermore, the demand rationales for the approach must be borrowed from one of the demand approaches. Young (2003) himself is well aware of these weaknesses. Although being a pioneer within the entrepreneurship approach to nonprofits, he recognizes that a more comprehensive framework is needed and suggests that the approach should be used to compliment the nonprofit demand theories. He particularly addresses the lack of explanatory power for the more routine based and the static side of nonprofits.

When it comes to the observed growth the nonprofit sector (confer subchapter 3.2), Badelt (2003) stresses that it needs not be based on entrepreneurial factors; it could also be a consequence of various demand factors. Further on, Badelt accentuates that while the existing entrepreneurship theories focus on three institutional choices, empirics underpin that the nonprofits entrepreneurs are very flexible and choose from a wide range of nonprofit forms. By such property, the nonprofit sector fills the gaps of ‘missing’ organizational forms (ibid.). At this point, it seems clear to me that introduction of more intuitional forms would imply a not substantial break with existing theory. As a simplification, one could also argue that the three existing intuitional alternatives (i.e. forprofit, public and nonprofit form) represent the most efficient arrangements within each subsector.

## **5.2 The Voluntary Failure Approach to Nonprofits**

In this subchapter, I will give an introduction to the voluntary approach to nonprofits. I run through Salamon’s version of the theory in section 5.2.1, before I render the core institutional criticism to the approach in section 5.2.2. As the name indicates, the voluntary failure approach originally emphasized the volunteer part of the nonprofit sector, but the approach could easily be adapted to the nonprofit sector more generally. Although not emphasizing specific supply factors, I find the approach’s analysis of the interaction between the public sector and the nonprofit sector enlightening.

### **5.2.1 Salamon’s Voluntary Failure Approach**

A possible approach to the study of nonprofits and the study of public provision of good is Lester Salamon’s voluntary failure approach from the 1980s. Traditionally, the mediating structure approach has treated the nonprofit sector as something in between the public sector and private sector. Salamon’s theory rejects the government failure approaches (e.g. the public good approach), where the sector simply could be considered as the best answer to market and governing failures (Wolpert 2003). Instead he proposes that the sector can be viewed as the ‘primary response mechanism’<sup>42</sup> for provision of public goods, in the sense that

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<sup>42</sup> It should be noted that Wolpert (2003) seems to have misunderstood Salamon’s original paper at this point; a misunderstanding Salamon (2003) comments on. Both Salamon and Wolpert used ‘preferred mechanism’ instead of ‘primary response mechanism’, as Salamon have done in latter works and I have done here. Whereas

it is the first sector to provide social beneficial goods that the private sector fails to provide. Next, the provision is possibly supplemented by the public sector through additional provision or partnership with the other sectors. According to Salamon (2003), the role of the government is primarily to be to compensate for certain shortcomings of the voluntary sector. He emphasizes the nonprofits as third party agents, delivering services funded under programs handled by the government.

Salamon identifies a wide range of market and governing failures, which the voluntary sector, and thereafter the public sector, responds to. Some of them could be remedied over time, including amateurism, paternalism and organizational failures, both throughout the bureaucracy and at the management level. Other failures are lasting, such as the insufficiency failures (i.e. nonprofits limited access to resources), particularism (i.e. the personal relevance of nonprofits activities varies across individuals) and localism (i.e. degree of local engagement).<sup>43</sup> Furthermore, Salamon finds empirical support for the desirable division of exercises not being universal by no mean. In contrary, he concludes that it depends on the welfare regime in question (i.e. corporatist regime, liberal regime, social democratic regime and statist regime, confer the social origin approach and subchapter 3.2) (ibid.).

Wolpert (2003) endorses Salamon's theory as a unifying approach to nonprofit theory and propose three incremental components to Salamon's framework. First, he makes a point regarding who should provide a specific good and to what extent. He argues that these questions should be seen in context of comparative advantages (with similar explanations as the other approaches, e.g. public good provision, trust etc.) and discussed in relation to crowding in and crowding out effects (confer section 7.1.2 about public support). Second, Wolpert highlights the nonprofits-public partnership, where the government on the one hand compensates the nonprofits for their lack of resources and particularism, and on the other hand, monitors and regulates their operations. Third, Wolpert stresses that the relationship between the public sector and the nonprofit sector should be viewed as a dynamic interaction. Salamon (2003) finds Wolpert's incremental components to be aligned with his theory.

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Wolpert interpreted Salamon's use of 'preferred mechanism' as some kind of personal preference for which mechanism that should be used, Salamon only meant that the mechanism typically comes into play before the potential public intervention. In other words, Salamon does not refer to a personal preference for nonprofits provision over public provision. He rather views public provision as a supplement (Salamon 2003).

<sup>43</sup> Salamon and Wolpert's preceding misunderstanding made Wolpert believe that Salamon favored extreme localism and neighborhood focus over public, when he fact view them as supplements (Salamon 2003).

### **5.2.2 Wolch's Institutional Criticism of Voluntary Failure Theory**

Wolch (2003) is critical to the voluntary failure approach, as well as other economic approaches and mediating structure approaches, where the voluntary sector is considered as independent. First, she claims that the approach neglects the structural, institutional and individual levels of social life and interaction, which varies a lot between nonprofit subsectors. Second, she asserts what she calls the neglect of public sectors autonomy, with references to the public sectors ability to implement reforms and its immunity against regulations. At this point, I believe Wolch's argument would have been stronger, if she had taken politically feasibility into account. Steinberg (2003) believes public goods and transaction costs provide a solid fundament for Salamon's theory. He calls for further integration between economics and political scientific theories. Furthermore, Steinberg (2006) asserts that the voluntary failure approach explains why consumers buy nonprofits good, and why donors donate to nonprofits. However, he misses a complementing supply theory to the demand approaches. Eckel and Steinberg (2009) attempt to develop a supply rationale by integrating transformers to Young's entrepreneurship approach (confer section 5.1.6).

As an alternative to the voluntary failure approach, Wolch (2003) argues with empirical references in favor of an institutional approach, where the voluntary sector acts as a response to public policy. The approach highlights the existing organizational culture and structure, as well as the operational incentive schemes and the surrounding cultural factors. She calls for an endogenous theory on how voluntary initiatives shapes and are affected by policies, which emphasizes differences in opinions, time and space. Another obvious limitation of the theory is that it primarily emphasizes the voluntary part of nonprofit sector, making it less relevant for the study of non-donative nonprofits. In context of the interaction between the nonprofit sector and the private sector, some of the voluntary insights could be transmitted as 'green theory' arguments for consumers, donors and workers, where the actors are prone to take a private economic loss for the common good.

## **5.3 The Organizational Behavioral Approach**

In this subchapter, I review the supply approach to nonprofits named the organizational behavioral approach, which brings in insights from evolutionary economics. I will start out going through the ecological and institutional selection models in section 5.3.1, and the

adaption model in section 5.3.2. These could be considered as much used corner stones to the organizational behavioral approach. Moreover, selection models follow the tradition of Darwinian evolutionary economics, whereas adaption models follow the Lamarckian tradition. Thereafter, I will go through Bielefeld and Galaskiewicz' macro-organizational theory in section 5.3.3 and provide some criticism of the theory in section 5.3.4. At last, I discuss the DiMaggio's ecological theory of nonprofits in 5.3.5, before I emphasize its weakness and strengths in relation to Bielefeld and Galaskiewicz model in 5.3.6.

### **5.3.1 Selection Models**

Selective models stress the importance of the environment, where an organization operates. In older versions the interaction between the organization and the environment is mostly duplex. In most recent versions, however, neither the manager nor the organization more generally adapt to a dynamic environment, except for possible change in organizational form. Selection in this regard refers to the alteration in the composition of a set of organizational form as one is replaced by another. Moreover, both the manager and organization's survival depends on whether their self-selection fits the environmental and organizational conditions (Bielefeld and Galaskiewicz 2003).

Selection theorists usually focus on one out of two environments; the ecological environment and the institutional environment. Ecological environments are the arenas, where organizations carry out their day-to-day operations, including all relevant actors (e.g. competitors, suppliers, customers and regulators), the population, the ecological community; and in more recent theory contributions; particularly industries. In contrast, institutional environments involve three types of confirmative structures, as well as stabilizing and meaningful social behavior. The three types of structures are cognitive structures (i.e. mimic of culture scripts), normative structures (i.e. internalization of meaning, norms and values through socialization) and regulative structure (i.e. enforcement through aversion against material consequences) (ibid.).

Generally, the institutional selection theory encompasses how external cultural patterns affect the organization. Both ecologists and institutionalists highpoint legitimacy in this regard. Whereas ecologists mainly draw attention to constitutive processes (i.e. cognitive processes where organizational forms can be taken for granted), institutionalists focus on socio-political

legitimacy (i.e. reward for behavioral conformity in form of contracts or social recognition). Bielefeld and Galaskiewicz find selection models most appropriate at the levels of population and communities. Nonetheless, they find the models too deterministic, since they ignore agency and the managers' freedom of choice, instead focusing on populations, resources particular industries (ibid.).

### **5.3.2 Adaption Models**

Adaption theory is a rationalistic approach to organizational theory, which claims that organizations, represented by the senior management, can and will adapt to their environment in order to survive and succeed. As a simplification, Bielefeld and Galaskiewicz distinguish between three sets of choices in strategic management, namely growth versus consolidation; internal focus versus external focus; and implementation of efficiency tactics versus implementation of legitimation tactics. Efficiency tactics implies reducing cost and enhancing sales, whereas legitimation tactics comprises conformation of norms, rules and policies. Adaption theory also endorses retrenchment, which although often being painful, could give organizations a comparative advantage. Most frequently, such processes occur in hostile environments (Bielefeld and Galaskiewicz 2003).

In Bielefeld and Galaskiewicz' opinion, adaption models draw too much attention towards managers' initiatives. The approach especially ignores the embedded conditions set by the environment. They criticize the adaption theorists for not distinguishing between intended, unintended and realized behavior; and thereby neglecting a reason for irrationality. Further on, the assumption about managers being rational and faithful servants of their organizations ignores suboptimality and opportunistic behavior, as well as the irrational behavior when facing treats, suggested by empirical evidences. Bielefeld and Galaskiewicz find the approach most useful on organizational level and occasionally on decision-makers' level (ibid.).

### **5.3.3 Bielefeld and Galaskiewicz's Macro-Organizational Theory**

Bielefeld and Galaskiewicz (2003) have developed a theory on macro-organizational behavior that aims to explain why some organizations embrace norms of efficiency and expend more on legitimation, while others do not. Thereby, they try to combine the insights from selection models and adaption models. Still, Bielefeld and Galaskiewicz are cautious about mixing



different levels of analysis, when doing so. Rather than drawing attention to organizational outputs and outcomes, they highlight variations in priorities and tactics. They choose to focus mainly on the differences between charity and forprofits, but their framework could easily be adapted for a more general comparison between forprofits and nonprofits. Bielefeld and Galaskiewicz claim that too much attention has been put on the non-distribution constraint in other nonprofit approaches. This is in line with Brody's (2003) argument, which rejects non-distribution constraint and instead proposes to distinguish between organizations with basis of the sectorial belonging. Bielefeld and Galaskiewicz (2003) rather want to highlight environmental conditions and strategic choice.

The theory underpins that organizations not only compete, but also cooperate. The degrees of competition and cooperation vary across different partial environments, which within this part of the literature are known as resource niches. Similarly, institutional niches are not mainly characterized by competition, but rather heavily influenced by institutional factors. The institutional framework involves outcome controls and process controls with various strengths, which in turn decide allocation of resources and the forms of interaction. Moreover, the institutional framework within niches can help to explain why organizations pursue efficiency and legitimation tactics. Organizations' tactics will be driven by the wish to maximize some objectives with respect to inputs. An organization's chance for survival depends on the products' quality and price, as well as the institutional conformity in each niche. Bielefeld and Galaskiewicz identify adaption as the mainspring in their model, rather than selection process. Still, they recognize that rules, norms and customs could affect the intrinsic motivation (ibid.).

Bielefeld and Galaskiewicz' theory suggest that forprofits and nonprofits should act differently, when niches vary, and similarly, when the niches are alike and both organizational forms survive. Hence, nonprofits will typically act in the same matter as forprofits in a niche with both legal forms, whereas behavioral differences between forprofits and nonprofits in different niches should be maintained. Bielefeld and Galaskiewicz believe that nonprofits have a comparative advantage in emerging industries and certain established sectors (e.g. charity, child welfare services, education, literacy and religious activity), much due to their institutional image and government support (e.g. tax exemption and tax-deductible contributions). By their comparative disadvantage, forprofits are encouraged to change organizational form. Moreover, both nonprofits and forprofits could be classified in terms of

strong and weak processes controls and output controls. Bielefeld and Galaskiewicz concludes that priorities and tactics of both forprofit and charities are functions of conditions in the various niches, in which they compete for resources in (ibid.).

### **5.3.4 Criticism of Bielefeld and Galaskiewicz' Theory**

In consistence with Brody's reasoning, Bielefeld and Galaskiewicz' (2003) neglect the non-distribution constraint, which often represents a vital factor in explaining the difference between forprofits and nonprofits in many of the other approaches. While having a lot to say about classification of institutions including nonprofits, Brody (2003) points out that Bielefeld and Galaskiewicz only to a limited extend distinguish between forprofits and nonprofits.

While Brody argues in favor of an activity-based classification of organizations with basis in their organizational form instead of their legal form (ibid.), I neither share the view that the legal form mainly plays a minor role, nor that its emphasis needs to come at the expense of less activity focus. Clearly, both Weisbrod's public good approach (confer subchapter 4.1) or Hansmann's trust approach (confer subchapter 4.2) address models that suits different kinds of nonprofit sector, highlighting the legal form.

I acknowledge Bielefeld and Galaskiewicz (2003) for explaining why the characteristics of forprofits and nonprofit acting within the same niches converge (e.g. Carlsberg Foundation, Det Norske Veritas), while differences between forprofits and nonprofits of distinctive niches are maintained (e.g. Zero Emission Resource Organisation versus Statoil). Not that many nonprofit theories pay attention to the fact that a nonprofit status may not alter major differences from forprofit in certain industries. Brody (1996) claims that forprofits, nonprofits and public enterprises are more alike than commonly believed, facing the same constraints of resource dependency, institutional isomorphism and organizational slack.

However, it seems like the explanatory power for similarities between the two sectors, might have come to the detriment of illumination of the differences. I also miss a more sophisticated discussion about the role of the public sector. Yet, the interior organizational implications of a nonprofit status have been widely neglected by most other approaches too. Steinberg (2003) calls for a deeper discussion of the border between the nonprofit organization and the market in line with Coase's transaction cost theory, which takes the financing mechanisms and stakeholder involvement more into account.

Brody (2003) argues that the distribution constraint does not prevent a nonprofit from using its surplus to compete for favored inputs; a notion that Bielefeld and Galaskiewicz (2003) adapt. Even if it might be responsible to assume that the constraint has less to say in some industries, I do not think the conjecture should be deduced to a general rule. Although primarily a supply theory, I believe they could have given more emphasize on important arguments from demand theory, such as provision of public goods and trust-based arguments, based on profit incentives rather than glorifying images. One could of course argue that such considerations are entailed by the treatment of the surrounding environments, but I am skeptical to whether Bielefeld and Galaskiewicz' framework would be sufficient.

An interesting feature of the theory is that the authors predict specialization or convergence in organizational behavior between nonprofits and forprofits in the same industry, and moreover adaption of efficient behavior. However, their desertion of moral hazard problems and contradicting behavioral factors seem a bit unfounded. These challenges could perhaps be seen in connection with the authors' treatment of competition and cooperation in the institutional environment. In relation to behavioral factors, Borzaga et al. (2009) argue that individuals and institutions should be treated as actors with complex motivational factors and the diverse nature of preferences, rather than self-interested profit maximizers. Adopting an evolutionary framework, they highlight the organizations contribution to economic development, social development and satisfaction of community needs, in addition to the traditional efficiency criteria related to survival in competitive markets.

In context of organizational change, Brody (2003) criticizes Bielefeld and Galaskiewicz for disregarding ownership change as a driving factor. Personally, I agree with Brody that financial rigidity is a disadvantage for nonprofit, although I can not see that this matter has caught much attention in any of the other approaches to nonprofits either (confer subchapter 7.2). At last, I believe Bielefeld and Galaskiewicz overestimate the role of tax advantages as a rationale for the study nonprofits. Even though tax exemptions and similar arrangements may play an important historical role for development of nonprofits, and inertia may imply long-term effects from past policies, any organization disregarding organizational form would gain from such arrangements. (This view is shared is shared by Weisbrod, confer section 2.3.1). There are also many other historical explanations for nonprofit operations, which due to inertia could explain much of the nonprofit landscape today (confer chapter 3).

### 5.3.5 DiMaggio's Organizational Ecology

DiMaggio's (2003) organizational ecology is an organizational behavioral approach to nonprofits in line with the school of evolutionary economics. Organizational ecologists embrace how organizational populations develop over time in response to environmental changes. Every organization in the population is characterized by vital rates (e.g. entry, exit, fission and fusion), and determined by masses and densities of total and competing populations, as well as economic conditions, prevailing public opinions, historical events and government policies. Each organizational form needs to find a distinctive niche in order to survive. According to the principle of competitive exclusion, two different species (i.e. organizational forms) cannot occupy the same niche (i.e. resource space) in a stable equilibrium.

Although not using the terms of the two evolutionary effects explicitly, DiMaggio believes that the Darwinian effects (e.g. metaphor for firms survival; all the short giraffes, which did not manage to reach the leaves on top of the trees, died, and only the tall ones survived) are stronger than Lamarckian effects (e.g. metaphor for firms survival; all the giraffes got longer necks after each generation). In other words, he argues in favor of replacement of market actors with particular institutional forms or strategies, being more important than firms' adaptation to environmental changes. Following the ecological approach, a nonprofit in an industry depends on its position and the niches that it occupies. Ecologists' studies indicate non-monotonic density dependence, where a new kind of organization increases slowly at first, and then sharply, when the market opportunity becomes prevalent. Thereafter, the trend dips as competition becomes tougher and resources scarcer, before the death rates eventually start to increase (ibid).

DiMaggio uses this path of organizational evolution to explain empirical indications for nonprofits being most successful in new markets where trustworthiness is less documented. He finds that ecological models are well equipped for cross-sectorial studies of the for-profit sector, the nonprofit sector and the public sector; identifying under which circumstances the various organizational forms exist and possess their own niches. Furthermore, DiMaggio adopts Ortmann-Schlesinger's three conditions for nonprofits being able to outcompete for-profit (i.e. overcoming the incentive compatibility challenge, the adulteration challenge and the reputational ubiquity challenge, confer section 4.2.4); or in ecological terms; nonprofits'

density affects forprofit' vital-rates negatively, but not visa versa. In addition to embracing the trust approach, DiMaggio enhances the public good approach, the stakeholder approach and the entrepreneurship approach as feasibly evaluable in an ecologic framework (ibid.).

In industries where forprofits concentrate through mergers, nonprofits are depending on finding their niches that small firms can occupy. DiMaggio mentions nonprofit micro-brewers as a typical example (ibid.), but fail to mention that the majority owner of one of the world's largest brewers, Carlsberg Group, is a foundation (Carlsberg Foundation 2012b). DiMaggio (2003) interprets the ecological theory on organization as vulnerable for policy changes. Furthermore, he highlights that regulatory variations make nonprofits more similar to forprofits. The distribution of power among internal stakeholders could be analyzed as a consequence of the organizations interaction with the environment. Lastly, considering the interior structure, fluctuations in the stakeholder population will influence the balance between employment in administration and operation.

### **5.3.6 Criticism of DiMaggio's Organizational Ecology**

As Bielefeld and Galaskiewicz's macro-organizational theory, it is not surprising that much of the same criticism on nonprofit relevance apply for organizational ecology. However, DiMaggio has to a larger extent thought of integration of the three prevailing demand theories, which should be considered as argument in favor of DiMaggio's approach. His description of nonprofits' life-circle is also illuminating. In the evolution of the nonprofit landscape, Bielefeld and Galaskiewicz put most emphasis on adaptations mechanisms (i.e. Lamarckian evolutionary arguments), whereas DiMaggio focuses on selection rationales (i.e. Darwinian evolutionary arguments). Furthermore, I find DiMaggio rationales for nonprofits and clearer distinction between organizational forms more credible. Yet, DiMaggio does not have the same multi-level strength in his model as Bielefeld and Galaskiewicz. A profound discussion of interior organizational issues would from my point of view have strengthened DiMaggio's approach.

## 6 Nonprofit Incentive Structures

Bacchiega and Borzaga (2003) argue that the supply side of nonprofit activity, in contrary to the demand side, has not been carefully studied, neither in the sense of entrepreneurship or interior incentive structure. In line with my perception, they claim that too little attention has been directed to the nonprofit's 'ability to remedy failures in the control of managers and workers (i.e. counter agency costs) and the possibility of attracting motivated managers and workers have been neglected' (Bacchiega and Borzaga 2003, page 31). They propose to view nonprofits in light of the incentive structures involved, not only in relation to workers and managers, but also in relation to donors and volunteers. In similar spirit, Van Hoomissen and Ben-Ner (1994) point out that the interests of board members, managers and workers within nonprofits may be in conflict with the founder's preferences.

Moreover, parts of the management and psychological literature seem very relevant for understanding how nonprofits can achieve competitive advantages on the supply side and fight contractual challenges; both by control mechanisms and behavioral factors. From my point of view, the lack of behavioral theory on issues related to the theory of the firm is a significant shortage in this field of economics, which becomes relevant for the nonprofit theory, when the behavioral factors either are; associated with the 'nonprofit status' of firms; able to counter nonprofits' interior challenges; or both. I will address remedies in line with standard contract theory in subchapter 6.1, while I treat behavioral factors such as motivation in subchapter 6.2. In the literature, the analyses in this chapter largely comply with the property approach to nonprofits.

### 6.1 Nonprofits in a Traditional Contract Theoretical Framework

Ben-Ner and Gui (2003) argue that the main weakness of nonprofits is the limited monetary incentives for founding and operating a foundation. Next, they conclude that nonprofit status will be chosen, if it has certain strengths to overcome this weakness, either due to certain demand side advantages, or because of supply-side incentives other than profit. In this subchapter, I will treat the interior issues of nonprofits without taking behavioral factors into

account. I will begin by discussing distribution of control rights in section 6.1.1, before I turn to the mechanisms behind the nonprofits' adaption in section 6.1.2. Next, I address the main interior issues of nonprofits; namely moral hazard and rent-seeking in section 6.1.3.

Thereafter, I discuss various non-behavioral non-control mechanisms of both external and internal characteristics in section 6.1.4. Finally, I finish the subchapter by my own Game of Internal Control in 6.1.5.

### **6.1.1 Distribution of Control Rights**

An in my view essential, but largely unexplored topic in the theory of nonprofits, is the distribution of control rights and the potential contract problems that follows. While owners obviously play a vital job as principals of forprofits, there are no obvious principals in the nonprofits at first glance; at least ex ante principals, after being founded. As discussed in section 2.3.2, Hansmann's (1980) classification distinguishes between the nonprofits where the beneficiaries keep the control rights after the establishment (i.e. mutual nonprofits) and those where the beneficiaries loose their control rights (i.e. entrepreneurial nonprofits). By the same token, Bacchiega and Borzaga (2003) underpin that beneficiaries' are likely to maintain control in certain cooperatives and associations. Furthermore, Ben-Ner and Gui (2003) suggest that the manager often is a beneficiary himself.

If either the founder keeps control over a nonprofit after its establishment, or lasting donors maintain control over time, an obvious implication is that they are better equipped to handle interior contractual challenges. On the other hand, their presence in the organization might be expensive. Entrepreneurial nonprofits will clearly face contract challenges. I address these in the other sections of this subchapter. Yet, the founder could still be considered as an ex ante principal. Steinberg (2003) proposes to consider the nonprofit as controlled by a board of directors that must obey the non-distribution constraint, but still has a lot of freedom. Nevertheless, he argues that the constraint does neither determine how the boards' representatives are chosen, nor how the competing interests of stakeholder's are dealt with. I will continue the discussion of the challenges with moral hazard and rent-seeking in section 6.1.3, and potential counter measures in the section 6.1.4 and section 6.1.5.

Hansmann and Thomsen (2009) propose that the governance of foundations may become interested in ensuring good performance in order to be rewarded with donations and

expansion. Yet, they pin out that there could also be an opposite effect, if the governance fear being replaced in an expansion process. Their results indicate that there might be gains from separating owners and organizations, in the sense that more ownership layers could diminish the chances for governance failure. Moreover, Hansmann and Thomsen predict that an extra control layer diminish the risk of bad investment projects being approved (i.e. fewer type 1 errors) at the expense of rejecting too many good projects (i.e. more type 2 errors).

According Bacchiega and Borzaga (2003), a widely neglected information failure occurs in the production of social services, deriving from incomplete labor contracts. They propose to focus on distribution of the control rights within organizations. In fact, they believe that distribution of control right could help explaining both the existence and differentiation of nonprofits. Bacchiega and Borzaga substantiate this matter by considering the case where the manager can affect the aim of the organization. Moreover, Wilsker and Young (2010) suggest that nonprofits' objectives could be affected by the income prospective of different activities. Besides, Bacchiega and Borzaga (2003) point out that the control structures of nonprofits often are unclear, particularly when control rights are separated from the residual income claims. Yet, it does not need to be absence. They propose that nonprofits are driven by redistributing concerns, demand activities or both, and that these driving forces are flexible (ibid.).

When redistribution is a sustainable component, it is hard to determine the trade-off between the democratic rights of organizational democracy, consumers' well-being, redistribution in favor beneficiaries and other concerns. In contrast, for activities involving a paying demand or fully public financing, the allocation of control rights are typically addressed to market failures and governing failures, characterized by care services. In this instance, control rights should be given to consumers, when internal redistribution is needed, and workers and managers, when share of organizational mission is important. Another possibility is that a redistributive objective is combined with handling of market and governing failures, which advocates spread of control rights. This is commonly the case for nonprofits, which provide services to both solvent and insolvent consumers without full public financing. For the nonprofits in question, it becomes essential to both reduce contractual costs and ensure sufficient funding through a variety of sources, that is private and public support (confer subchapter 7.1), voluntarism and green labor of managers and workers (confer subsection 6.2.6) (ibid.).



## 6.1.2 Nonprofits' Adaption

Per definition, nonprofits generally do not maximize profit. Instead they promote the desires of their beneficiaries, driven by different degrees of altruistic and egoistic motives. Although some nonprofits are able to distribute profits (e.g. cooperatives and mutuals), most nonprofits are restricted from doing so. As Bacchiega and Borzaga (2003) point out, the profit function becomes a restraint in the nonprofit's maximization problem, rather than the objective function itself. While the conventional argument underpins that the non-distribution constraint undermines the manager incentives for profits (confer section 4.2.1), Bielefeld and Galaskiewicz (2003) highlight both reduced incentives for consumer exploitation and suboptimization within the organization as possible challenges. They refer to Weisbrod, who introduces the term 'bonoficers' as an alternative to profit maximization for nonprofits; especially charities. Nevertheless, empirical research implies that there is some degree of profit maximization also in nonprofits (ibid.). On my part, I argue that short-term profit maximization is likely to be a natural part of dynamic optimization of social objectives in many cases, accompanied by external considerations. Thus, I did not find these empirical results that surprising.

In addition, the notion of social optimum maximization within nonprofits has been disputed and the empiric evidence is ambiguous. For instance, Hamilton describes nonprofits as more 'patient maximizers'. Furthermore, Clarke and Estes conclude that nonprofits tend to cooperate rather than compete, suggesting that the forprofit and nonprofit sectors build on different logics. However, they do not find major differences between forprofit and nonprofit home services. With basis in the nonprofits incentive structure, Bacchiega and Borzaga argue that nonprofits are best suited to compete on the provision of personal and community care services. In context of hospital services, Steinberg and Gray find that the forprofits are more costly for a 'third party' payer with possible higher wage expenditures as well (Bacchiega and Borzaga 2003). Ben-Ner and Gui (2003) stress that the non-distribution constraint is usually accompanied by a set of disciplining constraints to prevent rent-seeking and moral hazard; a matter I now will turn to in the preceding section.

### 6.1.3 Moral Hazard and Rent Seeking

In relation to the incentive approach to the theory of the firm, economists often look at the contract relationship between an owner and a selfish and rational manager. Roughly explained, the information problem between the two parties will occur, when the manager's effort is not directly verifiable for the owners. In principal-agent models of this kind, the owner has to decide whether it is desirable or not to ensure participation and provide incentives for effort. If effort is unobservable, the owner should typically base the manager's payment on another variable that is both verifiable and closely linked to the manager's level of performance, given that it does not make the manager extensively neglect other unobservable assignments related to his work. The fact that incentives are costly to implement will often result in a second-best solution, with lower effort for the manager than in a first-best solution without information problems. This phenomenon is known as moral hazard.

One major difference between a forprofit organization and entrepreneurial nonprofits, where the entrepreneurs loose control (adapting Hansmann's classification of nonprofits from section 2.3.2), is that the principal in the latter is not present ex post to observe, and to a large extent verify, the manager's level of effort. Within forprofits, the owners discipline the management and prevent them from shirking and rent-seeking. However, entrepreneurial nonprofits do not have any owners to control the management. It could well be that the performance of a nonprofit manager is verifiable, after implementing the project. Nonetheless, the manager's contract can typically not be based on this observation, since the founder loses control over the nonprofit, after its establishment. What is more, the performance is often not verifiable for a court of law. If we follow the conventional assumption that the manager is rational and selfish, and are not object to disciplinary mechanisms or behavioral characteristics, one should expect nonprofits to be dominated by moral hazard.

It seems somewhat unlikely that an ex ante principal is able to specify sufficient content to secure desirable behavior. Without any further restrictions, this obviously generates a serious moral hazard problem. In such an extreme case, the manager would put all of the foundation's funding in a pro forma project as capital input, make no effort and withdraw the value of the capital input through his own salary. An exception occurs, when the nonprofits have higher capital return than forprofits. Such differences in business prospects could stem from institutional inertia, technological advantages, potential tax benefits or more credibility of

being an idealistic firm in relation to green consumers (confer section 4.2.4) and green workers (confer section 6.2.6). In these cases, the manager will wait to present value for the withdrawal is at its highest or possibly make many withdrawals.

In the worst case, ‘the bad guys are taking over’-scenario will come to play, where the nonprofit are invaded by intruders for rent-seeking purposes (with references to Weisbrod categorization of nonprofits in section 2.3.1). Without sufficient control mechanism or idealistic behavior, there will thus always exist a danger of the nonprofit being evaded. In this, case, individuals or corporations would misuse the trust they are given, by attempting to enrich themselves at a social expense (Weisbrod 1988). Brody (1996) shares Weisbrod’s concern about ‘forprofits in disguise’. She suggests that the internal cost of moral hazard might exceed the external disciplinary gains from not being able to distribute profit directly. Moreover, she underlines that some legally designated persons have to decide the objectives and how to pursue them, in the absence of shareholders. Yet, Brody finds that also forprofit shareholders suffer from inefficiency costs of relaxed control rights. She proposes various stakeholders as possible principals in all nonprofits, not only the mutual type.

Krashinsky (1986) stresses that unscrupulous entrepreneurs could exploit nonprofit’s name to consumers’ disadvantage. What is more, Bielefeld and Galaskiewicz (2003) refer to the conventional argument that the incentives for efficient behavior are reduced by the non-distribution constraint, since the manager may not lawfully have a share in any surplus generated by his own executive performance. On the other hand, it can also prevent suboptimization, when there is a potential conflict of interest between an individual and the organization as a whole. Into the bargain, Ortmann and Schlesinger (2003) highlight the operators of nonprofit’s lack of profit motives as a problem by itself.

Badelt (2003) refers to studies which show that there are often complaints about lack of professional management in nonprofits, especially European nonprofit organizations. Furthermore, German economic literature on nonprofit suggests that efficiency problems regularly occur from an implicit understanding among nonprofits’ representatives that their organization should not earn profits (ibid.). Some empirical findings indicate that nonprofits occasionally have lower remunerations than their public counterparts, but generally larger than their forprofit competitors (Bielefeld and Galaskiewicz 2003). Kingma (2003) asserts that overpaid executives and misuse of funds may lead to a dramatic decline in donations for donative nonprofits. At last, Hansmann (2003) pronounces that nonprofits may succeed in

distributing some of their net earnings through higher salaries, granted perquisites to employees and other forms of excess payments, in spite of the limitations imposed upon them.

#### **6.1.4 Non-Behavioral Control Mechanisms**

There exist many control mechanisms with various capabilities to handle the interior contractual challenges in nonprofits. The behavioral counter measures are dealt with in subchapter 6.2. This section, I devote to both internal and external non-behavioral control-mechanisms. As mentioned in section 6.1.3, one would predict that the manager takes out as much as possible from the nonprofit subject to some interior disciplinary constraints. In line with this perspective, Ben-Ner and Gui (2003) highlight that the non-distribution constraint most often is supplemented by a set of disciplining constraints. These are established and implemented to preventing moral hazard and rent-seeking, and to ensure that the objective is pursued. I will argue that the founder may act as a principal ex ante, setting guidelines in the foundation document; or there could be some law or other legal restriction present. Such rules constitute interior disciplinary constraints for the management.

One way to cope with the organizational challenges of entrepreneurial nonprofit is to appoint an independent board of directors. It is also possible to specify procedures for such appointments in the foundation document. However, Ben-Ner and Gui (2003) point out that if the latter normally appoint by the former so, there are likely to be a problem. Glaeser (2001) and Shleifer mention that a governing board might be unable or uninterested in receiving high perquisites as a relevant internal control mechanism, possibly because it consists of the donors. They claim that nonprofits typically have such boards. Another way to avoid moral hazard is to introduce procedures of circular control, where different and enviably independent teams control each other. In section 6.1.5, I offer my own Game of Internal Control to illustrate some of the characteristics of circular control arrangements. In these Pareto coordination games, there will typically be one Pareto optimal Nash equilibrium and one Nash equilibrium characterized by moral hazard. I claim that larger nonprofits' Nash equilibriums will typically be more entrenched; and since they are large, they should be expected to be in the Pareto optimal equilibrium.

One could in addition label the types of control mechanisms by other types of formal and informal control systems, for instances crossing control systems along different lines of the

organization. The traditional principal-agent theory's prediction about moral hazard and rent-seeking is not totally contradicted by real-life observations. In January 2012, The Norwegian Foundation Authority<sup>44</sup> had about 400 cases (The Norwegian Foundation Authority 2012a) for above 8,000 foundations (The Norwegian Gambling and Foundation Authority 2012). In comparison, the supervision had above 800 cases for about 8,500 in 2010 (Mauren 2010). The small foundations were the ones, who were most exposed for internal irregularities (ibid.)

There also exist several possible external control mechanisms. Reputation and career possibilities in relation to the manager's outside option could for instance be disciplining. Another possibility is to hire external inspectors. In this case, the cost of external inspection should be weighted against the cost of moral hazard. Furthermore, the supervision for nonprofit could play an important role, even though their information basis is limited. DiMaggio (2003) claims that even if nonprofits attract altruistic managers, these dispositions might be fainted by pressure to adopt proprietary business practices. Furthermore, Ben-Ner and Gui (2003) believe that nonprofits can benefit from self-selection. Yet, they are aware that this opportunistic behavior; adverse selection; could occur as well, confer the 'bad guys taking over'-scenario mentioned in the previous section. Otherwise, I refer to subchapter 6.2 for discussions on behavioral control mechanisms.

### **6.1.5 The Game of Internal Control**

Foundations have often established control system to prevent moral hazard and rent-seeking. In larger foundations, a possible way to do this is to let different divisions of the organization control each other. This is done in a matter that does not allow any division to be controlled by the same division, which it is supposed to control. By circular control, nonprofits could cope with internal problems without any behavioral rationales.

In this section, I will provide an example of how a foundation's control mechanism can function or not function, within a game theoretical framework. I have named the example the Game of Internal Control. Empirical evidence (see for instance Lorentzen 2010, Mauren 2010 and The Norwegian Foundation Authority 2012) indicates that control mechanisms works in some foundations, but not in other. They also suggest that smaller foundations are more

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<sup>44</sup> The Norwegian Foundation Authority (2012b) is a part of The Norwegian Gambling and Foundation Authority.

exposed for exploitation than larger foundations (Mauren 2010), with weaker control mechanisms as a possible interpretation. Hopefully, the Game of Internal Control could help illustrate how seemingly similar control mechanisms could involve different kinds of outcome. As I will return to in a latter subsection, these mechanisms typically function better in larger nonprofits.

## The Basis of the Game

Let there be a foundation consisting of three management teams – *team A*, *team B* and *team C*. Team A is responsible for controlling team B, team B is responsible for controlling team C and team C is responsible for controlling team A. Mathematically, this corresponds to letting team  $i$  be controlled by team  $J(i)$  with  $i \in \{A, B, C\}$ , where  $J(A) = C$ ,  $J(B) = A$  and  $J(C) = B$ .

Each team can either choose to induce effort ( $E_i$ ) or to shirk ( $S_i$ ). When inducing effort, the team in question makes a profit for the common pot and inspects the team they are supposed to inspect. If the team on the other hand chooses to shirk, it will neither contribute to the common pot nor control the team, which it is set to watch after.

We further assume that the game is played simultaneously, where none of the teams know the other teams' actions, when making its own decision.

The teams that induce effort contributes with six to the common pot, which in turn is distributed to the three teams. Thus, the common pot becomes:

$$(3.1) \quad CP = \mu \sum_{j=1}^{n=3} P_j$$

where  $\mu$  is the return factor for contribution and  $P_i$  is a dummy for effort, which takes the value  $P_i = 0$  when team  $i$  shirks, and the value  $P_i = 1$  when team  $i$  induces effort. In my example, I set  $\mu = 6$ .

When shirking, the team does not make any profit for the common pot; nor does it inspect the team it is responsible for following up.

I let both the cost of inducing effort and the cost of being busted for shirking in inspection be 3. Further on, since effort and inspection are interlinked in my model by assumption,  $P_i = 0$

when not inspecting, and  $P_i = 1$  when inspecting. Similarly, we introduce a dummy for being caught shirking in inspection  $C_i(P_i, P_{J(i)})$ , which takes the value one being caught shirking (i.e.  $C_i(0,1) = 1$ ) and the value zero otherwise (i.e.  $C_i(0,0) = C_i(1,0) = C_i(1,1) = 0$ ).

Team  $i$ 's payoff becomes:

$$(3.2) \quad \pi_i = \frac{CP}{3} - 3P_i - 3C_i(P_i, P_{J(i)}) = 2 \sum_{j=1}^{n=3} P_j - 3I_i - 3C_i(P_i, P_{J(i)}) \text{ where } i \in \{A, B, C\}$$

We assume that all the teams are rational and egoistic, in the sense that they want to, and know how to, maximize their own payoffs.

## Solving the Game

The Game of Internal control illustrates how control mechanisms may or may not work. When none of the teams induces effort, neither of them will derive incomes nor costs. Thus, all teams will end up with zero payoff. In this situation, no team will have incentives to change their adaption given the other teams' adaptations, nor will they regret their choice of action. A change of strategy would imply a income of two and a cost of inducing effort of three, suming down to a payoff of minus one. It is therefore obvious that it is better to shirk. It follows that the action set  $\{S_A, S_B, S_C\}$  is a Nash equilibrium.

If one of the teams chooses to induce effort, while the two other shirk, the payoffs will differ. As mentioned above, the team that induce effort will regret its action. This hard-working team would wish that it had chosen to shirk like the others instead, and thereby obtained a payoff of zero, rather than minus one. In other words, the increased gain of two the team gets from the common pot is not enough to justify a cost from inducing effort of three. The team that shirks and is taken by control gets minus one, due to the cost of being busted in the inspection. This busted team would have wished that it had induced effort. By doing so, it would still have had a cost of three – now for inspection rather than beeing caught. Yet, the team's income from the common pot would have increased from two to four. Hence, the busted team would have increased its payoff from minus one to one, if it had induced effort. This team will therefore wish that it had acted differently.

In a situation where only one team chooses to induce effort, the only team which does not regret its action will be the team that shirks and get away with it. This team will have no costs whatsoever. Thus, its payoff will be equal to the income from the common pot, which is two. Since two out of three teams would want to change their action under these circumstances, the symmetric equivalent action sets;  $\{E_A, S_B, S_C\}$ ,  $\{S_A, E_B, S_C\}$  and  $\{S_A, E_B, E_C\}$ ; cannot be Nash equilibriums.

Next, if two of the teams choose to induce efforts, every team will obtain equal payoffs of one. All three teams will get a gross income of four from the common pot. The hard-working teams will be paying a cost of three for inducing efforts, while the shirking team faces a penalty of three, after being busted in the inspection. The busted team will have wished it had induced effort. Still, it would have had to pay a cost of three; now for inducing effort, rather than being busted in inspection. Yet, the income from the common pot would have been six, rather than four. The hard-working team, that the shirking team was suppose to inspect, would regret that it did not shirk as well. From this team's point of view, shirking would indeed decrease the income from the common pot from four to two. Nonetheless, the team would escape from the cost of inducing effort of three. What is more, it would not be caught for shirking, given the other teams' actions. Hence, a change of action from inducing effort to shirking would imply a increase in the team's payoff from one to two.

The hard-working team, that is inspected by the other hard-working team, will not regret its action. If this team had chosen to shirk instead of inducing effort, it would still have had a cost of three – now deriving from being caught in controll, rather than inducing effort. However, the team would have gotten less income from the common pot – two instead of four, decreasing the total payoff from one to minus one. Once again, two out of three teams would want to change their actions. It follows that the three symmetric equal set of actions;  $\{E_A, E_B, S_C\}$ ,  $\{E_A, S_B, E_C\}$  and  $\{S_A, E_B, E_C\}$ ; cannot be Nash equilibriums.

Lastly, there is the instance where all three teams are inducing effort. In this case the common pot is at its maximum level, and the fraction for each team will amount to six. Every team will pay three for inducing effort, resulting in individual payoffs of three. If a team had chosen to shirk instead, it would still have had a cost of three; now for being caught during the inspection. Nevertheless, the team's income from the common pot would have decreased from six to four, impying a decline in the payoff from three to one. Clearly, such change of



action is not desirable for any of the teams, implying that action set where all the teams induces effort;  $\{E_A, E_B, E_C\}$ ; indeed is a Nash equilibrium.

$\{E_A, E_B, E_C\}$  is also the action set that yields the highest payoff for all the players separately and obviously also combined. This Nash equilibrium is therefore Pareto optimal, and a movement from any of the other action set to this one would entail a Pareto improvement.

Below, I have illustrated the Game of Internal Control both by normal and extensive form. The interpretations are analogously to the ones above.

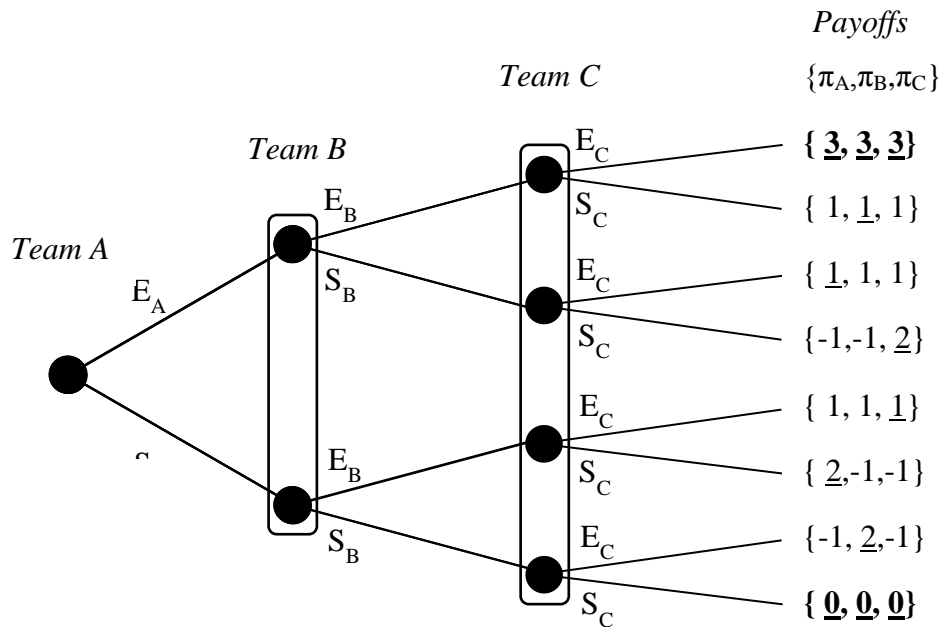
In both illustrations, each player's desired actions given the other players' actions in every situation are underlined. Furthermore, the two Nash equilibriums are highlighted with bold.

The normal form is given in table 6-1 underneath:

C	Effort (E <sub>C</sub> )		Shirk (S <sub>C</sub> )	
A \ B	Effort (E <sub>B</sub> )	Shirk (S <sub>B</sub> )	Effort (E <sub>B</sub> )	Shirk (S <sub>B</sub> )
Effort (E <sub>A</sub> )	<u>3</u> , <u>3</u> , <u>3</u>	<u>1</u> , 1, 1	1, <u>1</u> , 1	-1, -1, <u>2</u>
Shirk (S <sub>A</sub> )	1, 1, <u>1</u>	-1 , <u>2</u> , -1	<u>2</u> , -1, - <u>1</u>	<u>0</u> , <u>0</u> , <u>0</u>

**Table 6-1:** The Game of Internal Control on normal form: Each player's desired action given the other action is underlined. Furthermore, the game's Nash equilibriums are marked with bold and underlining.

The extensive form is given in figure 6-1 below:



**Figure 6-1:** The Game of Internal Control on extensive form: As in the normal form, the preferred actions given the other strategies and the two Nash equilibria are marked by bold and underlining. Dots mark the actions node, whereas the circular lines imply that the actor in question cannot distinguish between the different situations, since the game is simultaneous.

## Discussion

My Game of Internal Control is a Pareto coordination game with three actors. The rationale behind the game will be to illustrate how control mechanisms may or may not discipline the management in lack of a principal. The game is symmetric for all the teams and there are no dominant pure strategies. I neglect mixed strategies from my discussion, since I do not believe that the concept provides any further insight in this context. The gains of the game could be considered both as purely monetary costs and utility from the foundation's activities. Furthermore, the costs could on the one hand be related to inducing effort, and on the other hand, be caused by social stigma, bad reputation and possibly legal procession.

An interesting notation is that if one of the teams is a purely altruistic actor who always induces effort, the Pareto optimal Nash equilibrium will be the only Nash equilibrium. Similarly, if communication is possible, each team has little incentive to deviate from the Pareto optimal Nash equilibrium, knowing that one most likely will be busted for shirking. Observability, organizational and legal control mechanisms (e.g. rules from the foundation

document, legal dispositions, supervision and contractual commitments) and additional behavioral factors that are not already incorporated in the payoffs would all help to implement the right Nash-equilibrium. If we separate effort and control, and someone gets lazy in context of control, we could also be in deep trouble; especially in small nonprofits, where a single individual's decision has more impact on the total outcome. Contrariwise, the possibility of misjudgment and less credible punishment in case of control will weaken the equilibrium.

I argue that a more realistic (but still rather sterilized) dynamic game could have similar characteristics, with the Pareto optimal Nash equilibrium as the focal point and the subgame perfect equilibrium, even with informational lag. Strictly speaking, it is not clear what would have become the next outcome in a dynamic version of the game, if one start out outside one of the equilibrium. At least some of the different players would want to change their strategies, and the other players would expect them to do so. As long as one does not have strong contradictorily beliefs about the others' behavior or very high discount rate for future outcome, it would still seem rather odd not to induce effort, knowing that one would risk ending up in the wrong Nash-equilibrium. Conversely, punishment lags or information lags in case of control will weaken the equilibrium. Yet, more advanced three-actor punishment strategies related to for instance the tit-for-tat strategy and the grim trigger strategies could be applied in order to secure the desirable outcome, but for low discounts rates and in absence of informational and punishment lags, such sanctions are likely to be less credible.

Although a major simplification, I believe the game illustrates pretty well how control mechanisms may or may not work, depending on the initial situation. If the nonprofit on the one hand is in a good state, it is likely to stay there. If it on the other hand is caught up by a bad pattern, it could be hard to get out. I especially believe that a good pattern is sustainable for larger foundations, where many control mechanisms prevails, and a corrupt or lazy person cannot change the equilibrium easily. Moreover, individual actions have more impact in smaller organizations. I argue in line with empirical evidence (Mauren 2010) that the smaller nonprofits' control mechanisms are more unstable than the control mechanisms of the larger nonprofits. More generally, Bhatnagar and Nair (2011) find that nonprofits ran by idealistic leaders are vulnerable to changes in the management. A large foundation in the Pareto optimal Nash equilibrium is likely to stay there, whereas a potential large foundation in the undesirable Nash equilibrium is unlikely to be large in the first place. Conversely, the punishment may seem less credible for smaller foundations and one person's laziness could

have fatal consequences. Moreover, the threat of punishment is less credible and the board of directors or management is often hard to overthrow, even if shirking is detected.

## 6.2 Behavioral Factors

The conventional behavioral hypothesis within economic theory is the *Homo Economicus hypothesis*; i.e. the individuals are rational egoists who maximize their own utility based on external motivational factors, without taking others' utility gains into account. Traditional economic theory is occasionally criticized by behavioral economists and professionals from other branches of research for not taking behavioral factors into account. In this framework, inducing effort is associated with a perceived cost of shirking, whereas intrinsic motivation factors are typically neglected. Behavioral factors that affect the way people acts will of course have an impact on how organizations function. From my point of view, they are likely to be one of the very main reasons for why many nonprofits function so well, counteracting predictions about moral hazard and rent-seeking.

In this section, I will run through some of the behavioral factors that are likely to be important in this context. It should be noted, though, that in order for these behavioral factors to be relevant for the study of nonprofits, they must both have impact on the organization's performance and differ in some way between forprofits and nonprofits, or they must help nonprofit deal with their peculiar organizational problems. I begin by looking at motivation in section 6.2.1 and organizational culture in section 6.2.2. Next, I discuss job satisfaction, organizational commitment and transformational management in section 6.2.3, section 6.2.4 and section 6.2.5, respectively. Thereafter, I discuss how green worker theory could be relevant for and applied on nonprofits in section 6.2.6. At end of the subchapter in section 6.2.7, I review a new development in the literature, namely the attempt to merge principal-agent theory with stewardship theory.

### 6.2.1 Motivation

Motivation is defined as the biological, psychological and social factors, that activates and provides direction for organizations and maintain behaviors to various degree of intensity in relation to the achievement of objectives. The source of external motivation lies outside the work activity itself, typically in terms of a wage incentive structure. In context of economic

incentives, external motivation primarily promotes quantitative performance, seeing that high qualitative performance is hard to observe and verify. In the case of intrinsic motivation, on the other hand, the motivational source lies within the execution of the work itself. Such motivation typically stems from needs for competence development, perceived influence on the process and recognition for good work (Kaufman and Kaufman 1996).

Several of the explanations for how nonprofits manage to overcome the organizational failures addressed in subchapter 6.1 are related to arguments that suggest that intrinsic motivation counter the lack of monetary incentives in absence of sufficient control mechanisms. I therefore find it expedient to go through some insights from the theory of motivation regarding intrinsic and external motivation. From my point of view, theories of motivation should be considered interesting among economist, *inter alia* because they provide other important reasons for choosing a job than wage levels, and since they can explain how behavioral factors could counter moral hazard. If nonprofits are perceived especially motivating to work for at a given wage level, this will obviously provide advantages these firms, *contra* forprofits (confer section 6.2.6 on green worker theory below). Such perception could occur when nonprofits are perceived as more idealistic, or if they focus more on qualitative and loosely output-related tasks that are perceived as exciting.

### **Motivator-Hygiene Theory**

One of most influential researchers on the motivation theory in the 20<sup>th</sup> century was the American psychologist, Frederick Herzberg (*ibid.*). Herzberg (1959) introduces the Motivator-Hygiene theory, where he distinguishes between hygienic factors and motivational factors. Hygienic factors have to be fulfilled to a certain extend to keep workers from being dissatisfied, but does only to a limited extent affect the way the workers are motivated. Herzberg exemplifies the hygienic factors by organizational policy, interpersonal relationships, management, wage structure and working conditions. Conversely, motivational factors motivate the workers in a positive sense and require that at least a minimum set of requirements regarding the hygienic factors must be satisfied. According to Herzeberg, these factors include performance, recognition, responsibility, the work itself and personal realization. It should be noted that there could be drawn close links between external motivation and hygienic factors on the one hand, and internal motivation and motivational factors on the other.

Based on the lessons taken from his Motivator-Hygiene theory, Herzberg recommended a job enrichment program, giving the employees the opportunity to intellectual stimulation in accordance with their abilities. Job enrichment is a qualitative term, which involves an improvement through personal development. By such stimulation, the employees could to a large extent have coinciding incentives with the employees. Stimulation could be secured by providing them with constructive feedback and task with various difficulties, which are perceived as meaningful (Herzberg 1987). Job enrichment quantitative counterpart is job enlargement, which implies more duties, increased workload and more responsibility. Empirics indicate that job enlargement is positively correlated with job performance up to a certain point (Brief et al. 1976).

### **Job Characteristics Model**

Due to lack of empirical evidence for the Motivator-Hygiene theory, Richard Hackman and Greg Oldman have suggested a more systematic model based on motivation potential, known as the Job Characteristics Model. The authors highlight five subjective core job characteristics that are decisive for the intrinsic motivation potential. First and second, skill variety and perceived task significance are assumed to be immersive for the workers intrinsic motivation. Third, the intrinsic motivation increases with task identity, in the sense that one recognizes the exercise as an important task by itself, and not just only a small piece of the greater picture. Fourth, the exercise's autonomy, meaning the control and responsibility over own work, makes the worker feel more valuable and appreciated. Last, feedback provides both a lesson for future work and potential reward recognition for good work (ibid.). Empirics show some support for the theory. However, it must be underpin that individual differences play an important role in the motivation formation, involving differences in the need of personal development and job satisfaction, as well as different knowledge and abilities (Kaufman and Kaufman 1996).

### **Empirical Evidence for the Importance of Motivation**

Surveying a number of empirical studies, Bacchiega and Borzaga (2003) suggest that nonprofits tend to combine monetary rewards and other rewards, where the monetary component is of smaller magnitude than for forprofits and public firms. According to them, the monetary dimension may not even be the most significant component. Bacchiega and

Borzaga also embrace a study by Bruno Frey, which indicates that external motivational factors could crowd out internal motivational factors. In addition, they refer to an empirical investigation by Katz and Handy, which concludes that the challenges with shirking managers and workers could be limited or eliminated by employing motivated staff. Further empirical backing for the significance of intrinsic motivational factor will be provided in the sections to come. In general, the empirical research suggests that intrinsic motivation make the nonprofit sector more armed to oppose opportunistic behavior, than forprofits and public firms.

### **6.2.2 Organizational Culture**

One might expect nonprofits to more easily achieve an idealistic and well-functioning organizational culture than forprofits, because they have other aims than earning profits. If nonprofits are perceived as more credible as idealistic employers, it may give them a competitive advantage. Organizational culture is an intersubjective pattern of assumptions for, and interpretations of, learning and problem solving; both inside the organization and in the surroundings; shared by the members of the organization (Jacobsen and Thorsvik 2002). The core values could be divided into instrumental values and target values. Loosely speaking, instrumental values involve ‘the way we do things around here’, whereas target values reflect ‘the things we want to achieve’. Norms are rules and expectations on how to behave and react in line with the prevailing values. Alternatively, one could distinguish between inner and outer job values, the first referring to the execution of the exercises, and the latter referring to the consequences. An organizational culture is primarily determined by both internal and external ways of communication; focus on individuals and groups; tolerance for conflict; and differences of opinion and risk. In addition, it is influenced by more structural factors such as organizational aims, degree of control and wage structures (Kaufman and Kaufman 1996).

The organizational culture is decisive for how norms and collective values are established, maintained, changed and terminated. Since the culture affects the learning and problem-solving within the organization, it will have a direct influence on the organization’s performance. Organizational culture is established by a organizational framework (e.g. reward structure) and social interaction (e.g. sharing of perceptions and way of cooperating). It is maintained through expression forms, rituals, socializing and symbols. Furthermore, the organizational culture survival depends on support from the inner and outer environment. Lastly, substantial changes in the organizational culture are usually related to either

spontaneous or long-term processes. The ability to influence the environment in a desired direction is closely related to transformational management, confer the next subsection. Organizational culture may also influence the employees' way of thinking and relationship to the organization, making it even more remarkable in a performance context (Jacobsen and Thorsvik 2002).

## **Sub Cultures**

There can also be several subcultures within an organization. In case of many subcultures, it becomes crucial for the organization that the subcultures work for the common good, rather than sub-optimize. Bielefeld and Galaskiewicz (2003) claim that various subcultures in nonprofits could be overcome by weaken the profit incentive of suboptimization. Furthermore, they stress that team work will have implications for the workers' choices of effort level. I believe that team work has countervailing effects on the workers' effort. On the one hand, individual performance could become less identifiable in joint projects with many workers, with free-riding as a possible outcome. On the other hand, a joint project could discipline the workers involved through a feeling of responsibility and social pressure for making a good effort. Bacchiega and Borzaga (2003) conclude that although behavioral factors are likely to reduce nonprofits-opportunistic behavior, it seems unlikely that the problems will disappear completely. As a consequence, they believe that the nonprofit sector is likely to be unstable. Furthermore, German economic literature on nonprofits accentuates that interior conflicts could be a result of unclear formulation of aims (Badelt 2003).

## **Organizational Climate**

An implication of the organizational culture is per definition the organizational climate. The organizational climate is the atmosphere and social interaction manners that follows from the organizational culture. Schein suggests that organizational climate could be considered as an expression of the underlying organizational culture. Furthermore, Ekvall claims that the organizational climate in terms of organizational and psychological processes is a part of an interaction with resources (e.g. competence, materials, products and reality perception) and outcomes (e.g. quality, innovation, job satisfaction and productivity) (Kaufman and Kaufman 1996). Two vital outcomes of having a good organizational climate; job satisfaction and organizational commitment; are discussed in section 6.2.3 and section 6.2.4 respectively.



## **Nonprofits' Organizational Cultures**

Bacchiega and Borzaga (2003) emphasize the social dimension of as an important factor for providing a favorable incentive structure in a nonprofit. In this regard, they highlight three highly interconnected features. First, the existence of an explicit social objective will make the workers more capable in seeing the value of their own work and measure their own performance. In this context, explicit social aims and monetary aims are largely mutually exclusive. Second, the direct involving of beneficiaries could create desirable reciprocal trust relations. Here, a higher degree of self-determination for the employees' work awarded through low-powered incentives can be applied to achieve non-monetary objectives. Third, participation and democratic management make the workers feel important and appreciated. As a consequence, they become more satisfied with their job. When it comes to potential opportunism, Ben-Ner and Gui (2003) argue that if the members of a mutual nonprofits care about each other and observe each other, they could apply social pressure on shirkers and endorse codes of behavior that promote the group's common interests. They label this phenomenon of cooperation and trust as 'social capital'.

### **6.2.3 Job Satisfaction**

A central term often seen in relation to motivation is job satisfaction. Job satisfaction could be viewed both as a positive attitude and a positive emotion related to own work. It depends on the interaction between expectations, needs and values on the one hand, and the job situation's implications and possibilities on the other hand (Kaufman and Kaufman 1996). In his empirical investigations, Borzaga finds that nonprofit workers generally have a higher level of job satisfaction than forprofit and nonprofit employees. Other empirical findings suggest that workers in the nonprofit sector have higher job satisfaction than forprofit and public employees, since the sector's wage structure is perceived as fairer (Bacchiega and Borzaga 2003). Valentinov (2007b) finds that too high administrative and monetary incentives could crowd out intrinsic motivation. He concludes that the ability to develop and utilize intrinsic motivation enables nonprofits to mobilize more resources, and thereby ensure their own survival. These effects are present in forprofits as well, but they are often more important in nonprofits, since intrinsic motivation is likely to play a larger role in these organizations.

Borzaga and Tortina (2006) find that job satisfaction is driven by intrinsic motivation and relational work attitudes, whereas workers motivated by monetary gain tend to be less satisfied. Moreover, nonprofits' employees tend to be satisfied with their job due to an incentive mix of worker involvement and other processes related of the job. Intuitively, it seems reasonable to expect a positive relation between job satisfaction and job performance up to a certain point, although one might expect the relationship to be negative, if the job environment becomes situation too social. According to Kaufmann and Kaufmann (1996), Bono, Judge, Patton and Thoresen find that the direct correlation between job satisfaction and job performance is about thirty percent. This correlation was increasing in the complexity of the work exercises. Job satisfaction is also negatively correlated with factors that are negatively correlated with job productivity, such as staff turnover and job absenteeism.

#### **6.2.4 Organizational Commitment**

Another important individual factor, which is positively correlated with productivity, is organizational commitment. Organizational commitment is defined as an attitude that reflects the strength of the individual's identification with, and involvement in, the organization he works for. The main reason for stimulating employees' organizational commitment is to increase the organizational performance directly, by making them induce a higher level of effort. Besides, organizational commitment is likely to enforce organizational performance indirectly, for instance by reducing the turnover rate and increase job satisfaction (Kaufman and Kaufman 1996). Borzaga finds that nonprofit workers become less inclined to change employer, due to higher job satisfaction. Studying the Italian social service sector, he concludes that a large majority of the workers in social cooperatives and other associations choose their jobs, because of the contents (Bacchiega and Borzaga 2003).

The degree of committing work engagement is a complex matter. Meyer and Allen (1991) suggest that job satisfaction could be categorized along three dimensions. First, an affective commitment reflects a person's willingness and propensity to work for an organization, due a common set of values. Second, normative commitment involves a perceived obligation caused by social pressure and perceived expectations on ways to act. Last, continuance commitment reflects the wish to continue, due to a perceived switching cost, inter alia resulted by the investments one has made in terms of close colleagues, firm-specific and acquired pensions, firm-specific knowledge and so on.

Among these dimensions, affective engagement is directly linked to perception of the organization as an idealistic institution. This type of commitment could make the starting point for the green worker theory, highlighted in subsection 6.2.6. Continuous engagement and normative engagement do not depend directly on the idealism associated with the organization, but may well be self-reinforcing for the organizational climate present. When dealing with normative commitment, we could face a Nash-coordination game in accordance with the discussion on control mechanisms in the section 6.1.4 and in line with my game of internal control in section 6.1.5. In light of his empirical investigations, Mirvis finds that workers in nonprofits are generally more concerned about the social outcomes of their work, than public and forprofit workers (Bacchiega and Borzaga 2003). Furthermore, Borzaga and Tortina (2006) find that workers tend to be more loyal, when they are satisfied with the economic and process-related aspect of their work. They find that worker involvement is a typical characteristic among nonprofits.

## **6.2.5 Transformational Management**

Neoclassic economic theory builds on ‘transactional management’ based on exchange of values (e.g. work for money) and self-interests. However, the management literature embraces another sort of management as more effective in motivating workers; namely ‘transformational management’. Transformational management is directed to inspire employees to commitment and engagement to the organization’s mission. Whereas transactional management motivates through external factors, transformational management highlights intrinsic motivation. The aim is to create a common perception of reality and realization of values by collective engagement. Instead of having a manager that gives the workers orders, there is a two-way communication line between the employer and the employee (Jacobsen and Thorsvik 2002). I believe the theory of transformational could be appropriate for explaining organizational behavior within sectors, where autonomy in the job situation is of importance.

According to Badelt (2003), Peter Drucker describes managers of emerging nonprofits, as individuals, who want to succeed in bringing something new into the markets. By the same token, Bhatnagar and Nair (2011) claim that nonprofit leaders are especially committed to keep their nonprofit’s mission alive. Furthermore, Bacchiega and Borzaga (2003) highlight democratic management in nonprofits, where workers, managers, clients, customers and other

stakeholders are involved (confer section 6.2.2 on organizational culture). They promote this kind of management as a way of engaging workers and provide a wage structures that are perceived fair (confer section 6.2.6 on organizational culture). Moreover, Bacchiega and Borzaga assert that the open and democratic management of nonprofits plays an important role in redirecting strategies, when contractual relations are loosely defined, such that they are in accordance with the organizational objective (ibid.).

### **6.2.6 Green Worker Theory**

According to Brekke and Nyborg (2008), corporate social responsibility (CSR) can improve firms' ability to recruit highly motivated employees under unobservable effort, if they in addition to wage, care about corporate responsibility. The authors distinguish between socially responsible firms (i.e. green firms) and non-responsible firms (i.e. brown firms) on the one hand, and between idealistic workers that care about CSR and shirk little (i.e. green workers) and selfish workers that do not care about CSR and shirk more often (i.e. brown workers) on the other hand. Brekke and Nyborg show that green firms may be able to use screening devices for self-selection, and thereby obtain a competitive advantage. This remains the case even when the green workers willingness to pay for green employment is rather limited and their numbers are low (ibid.).

A possible explanation for the successfulness of some nonprofits is their ability to attract idealistic workers. As for green consumer theory reviewed in section 4.2.4, I argue that the missing link between green worker theory and the nonprofit theory is the perception of the nonprofit organizational status as possible signal for corporate social responsibility. Given that nonprofit organizations appear more credible as a social responsible employer than forprofits, the theory could help explaining how nonprofits, which are not wage-leading, could attract highly qualified workers. There is plenty of empiric evidence for nonprofits making more use of volunteer labor, than any other forms of institutions (Badelt 2003). Ben-Ner and Gui (2003) underline that voluntarily contributions by beneficiaries could help nonprofits compared to forprofits. I find it responsible to assume that such contributions will depend negatively on the diversity of interests and positively on potential contribution glows or presence of altruism, as long as the contributor is idealistic or believe she can give a significant contribution. Voluntary contributions might seem less relevant for commercial

nonprofits, but one could adapt similar reasoning for these firms by imagine increased propensity to induce high effort among beneficiary workers.

An adjacent hypothesis would be that similar mechanisms could dampen the wage demand in some nonprofit business. For instance, due to its social aims and lack of profit incentives, the nonprofit could be perceived as a defender of the common good. In an environment with asymmetric information and pressure for quantitative performance, nonprofits could also have a higher prioritizing of advanced and complex tasks, *inter alia* related to high-skill performance. If the employer have preferences over such characteristic, it could give nonprofit an advantage *contra* forprofits before they face each other in the job market. Frank (2009) argues that altruistic motivation could be captured by considering wage as a function of a public good, where the worker in question is willing to give up some of his wage for more public goods. I adopted in my motivated worker extension of Schiff and Weisbrod's public good model in section 4.1.3 and brought up the American university sector as an example.

I have myself worked in the Norwegian foundation, Det Norske Veritas (DNV), which is engaged in various business fields within the energy and maritime sectors. Many of my colleagues claimed that DNV is not wage leading, but felt instead some affiliation and affective commitment to their employer in terms of their rather idealistic aims. Borzaga and Tortina (2006) research indicate that worker satisfaction and loyalty play an important role in nonprofits. Nevertheless, I have no empirical justification for this being the case in DNV, and further empirical investigations should be carried out before making any further conclusions. Yet, I find these comments and observations interesting, and I would not be surprised, if they could help explaininf the existence and survival of some nonprofits, if not for DNV.

Admittedly, DNV also had some fringe benefits in terms of an extra week of holiday (DNV and VEFF 2010) and support of environmental initiatives (Lindøe 2007, 2011)<sup>45</sup> (confer the discussion in subchapter 6.1).

One may argue with basis behavioral factors discussed in the previous subsections that the right 'fringe benefits' could increase the workers' motivation, and thereby the productivity, up to a certain point. Nonetheless, empirical studies of other firms do not find evidences for such effect. Bacchiaga and Borzaga (2003) point out that monitoring of workers' effort and

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<sup>45</sup> These articles are obtained from DNV Inside and attached in the end of my thesis.

providing a well-functioning incentive structure are likely to be challenging in the instances of non-standardized and redistributive services. Facing these issues, it becomes crucial for the organizations to mobilize financial and human resources that are willing to contribute or exert effort for more than just monetary reasons. Numerous empirical studies have shown that nonprofit pay their workers less than their public counterparts, and every so often, less than their forprofit competitors. Other studies also display that professional workers tend to have lower wages in nonprofit firms (Bacchiega and Borzaga 2003, Steinberg 2003), which contradicts contract theoretical predictions of dominating moral hazard premiums (confer section 6.1.3).

Furthermore, some research indicates a wage compression between the public and nonprofit organizations in the same sector over time, while other empirical findings suggest that voluntary contributions decreases the wage level of paid employees in the nonprofit sector. The organizational structures of nonprofits seem to make them more enable to generate an incentive scheme for managers and workers, which is consistent with the organizations' objectives (Bacchiega and Borzaga 2003). I would like to remind the reader that a similar theory for green consumers is rendered in section 4.2.4. In addition, I showed how both green consumers and green workers can be integrated to a nonprofit framework in section 4.1.3.

### **6.2.7 Principal-Agent Theory Meets Stewardship Theory**

In recent literature, Belgian authors have proposed a unification of principal-agent theory and stewardship theory. While principal-agent theory highlight the moral hazard problems and the interest conflict between the principal and the agent, stewardship theory focuses on the common interests of the two parties and intrinsic motivation (Caers et al. 2006, 2011). Caers et al. (2006) point out that a unified theory could be applied both on the relationship between the stakeholders and the management, and the relationship between the management and the workers. What is more, Caers et al. (2011) combines the theories with the stakeholder approach, analyzing how various stakeholders could act as multiple principals. Personally, I find this new research both exciting and promising, and I hope one succeed with a formalization of the unified approach in the years to come.

# 7 Financing of Nonprofits

The last chapter before the conclusion, I devote to the financing of nonprofits. I begin by giving a short glimpse on the literature that regards sources of financing for nonprofits in subchapter 7.1. Then I round off by discussing one of the least explored remedies of nonprofits in subchapter 7.2; namely financial rigidity challenge. During the last year, new and possibly groundbreaking literature has emerged on this field, which I will address in this subchapter.

## 7.1 Sources of Financing

To some extent, nonprofit organizations choose a mixture of financing sources. These include private support (e.g. private donations and labor donations), public support (e.g. public financing and tax advantages), fees and sales. Sales are obviously the most relevant source of income for non-donative nonprofits in the business sector, but the other sources are not irrelevant for commercial nonprofits in general. According to Weisbrod (1998), the nonprofit sources of financing illustrate their interdependence with the private and public sectors. What is more, Wilsker and Young (2010) find indications for nonprofit financing often being mixed, due to different interests among the stakeholders. Besides, Fischer et al. (2011) find evidence for nonprofit financing being highly dependent on the nature of the goods they provide, which could be private, quasi-public or public. Since the analysis of sales income is more straightforward than the analysis of donations, I will devote much of this chapter to the discussion about donations and crowding effects. I will discuss private and public support in section 7.1.1 and section 7.1.2, respectively, before I turn to fees in section 7.1.3 and sales in section 7.1.4.

### 7.1.1 Private Support to Foundations

Generally, a donation is made because the donors prefer it over non-donation. I disregard irrational behavior as a less important factor in this respect, although impulsive behavior and ‘multiple selves models’ obviously could provide some explanatory power. Stenberg (2003) points out that direct donation and voluntarism could be considered either as an egoistic good (e.g. guilt alleviation, ego gratification) or a more altruistic good (e.g. care for the recipient,

paternalistic altruism). Yet, he considers such normative interpretations and evidently unobservable characteristics to be less relevant for empirical analyses.

Private charitable donations to nonprofits include bequests and gifts from individuals and private organizations, whether they are given directly or through fundraising efforts (Anheier Salamon 1996). Some authors have claimed that nonprofits could provide some kind of ‘social glow’ to contribute to community promoting activities (Ware 1989). Another possible rationale is altruistic preferences. Steinberg (2003) asserts that voluntarism could be viewed as donations of labor inputs. People tend to be more inclined to volunteer for nonprofits than forprofit, due to nonprofits’ lack of profit incentives. Yet, he believes that the succeeding comparative advantage is often damped, because of amateurism. Green worker theory and to some extent voluntarism was discussed more broadly in section 6.2.6. A similar parallel could be drawn between donors and green investors.

In line with Weisbrod’s use of Black’s median voter theory (confer section 4.1.1), Bacchiega and Borzaga (2003) stress that some of the charity nonprofits could be considered as an expression for dissatisfaction regarding the income distribution in the society. More concretely, some parts of the population may feel that poor layers of the population do not get fulfilled what it considered to be basic needs, by their own effort or through public arrangements. Ben-Ner and Van Hoomissen (1991) propose heterogeneous preferences must be fractionalized, with a critical amount of people dissatisfied with the prevailing public policies, in order to solve free-rider problems. Kingma (2003) refer to a study by Bergstrom, Blume and Varian, which indicates that the choice of donations is not chiefly a matter of how much one want to contribute; it is rather a matter of contributing or not.

Despite of game-theoretical predictions of benefits from free-riding, Kingma (2003) asserts that most experiments show that many individuals make voluntarily contributions. In this context, I miss an empirical study of sponsorship. More generally, it would have been interesting to investigate the differences between conditional and unconditional donations. Steinberg (2003) also considers the impact of tax systems. On the one hand, high overall taxes reduce the relative cost of volunteering versus working for pay. On the other hand, a high tax level increases the alternative value for charitable donations. Most studies indicate that the former effect dominates, although the results are a bit ambiguous. Tax breaks for donations tend to increase them temporarily, but it is unclear if there are any lifetime effects.



## 7.1.2 Public Support to Foundations

Public support to nonprofits includes direct grants, tax exemptions and assignments of valuable contracts. The magnitudes of the governments' support to foundations are considerable in almost every country (Anheier and Salamon 1996). Krashinsky (2003) suggests that the government might want to finance a nonprofit's provision of a good rather than providing it itself, for two reasons. First, the absence of competition and firm performance indicators could result in inefficient public production. Second, supporting nonprofits provides a way for the public sector to finance political sensitive, but yet socially beneficial, goods and services. Furthermore, Badelt (2003) emphasizes nonprofits innovative ability, filling in the gaps that the public sector fails to fulfill. Typically, the corresponding exercises are later taken over by the public (confer subchapter 3.2). What is more, Bacchiega and Borzaga (2003) claim that the nonprofit sector is extremely sensitive to public policies and that the sector therefore is unstable.

In line with voluntary failure theory and contrary to many earlier theories, Anheier and Salamon (1996) suggest that the two sectors should be considered as complementary, rather than substitutes. Ware (1989) does for instance argue that provision of non-market goods should be supplemented by nonprofits in addition to the government, since the public sector tends to undermine the need for provision. He points out that nonprofits could have both information and cost advantages. Through their empirical investigations, Anheier and Salamon (1996) find that nonprofits cooperate well with the public sector and commonly expand their activities, rather than replace them. Nevertheless, they recognize some challenges concerning the supervision of nonprofits. They also stress how both the nonprofit sector and the public sector could respond to various market and governance failures, inter alia discussed in subchapter 4.1 and subchapter 5.2. I refer to subchapter 3.2 for a brief empirical review on how the public sector complement and substitute each other in different countries, with references to Anheier and Salamon's social origin approach. In addition, I refer to subchapter 2.2 for a discussion about public enterprises.

As mentioned in subchapter 5.2, Wolpert (2003) also discusses partnerships between nonprofits and the public sector. He asserts that; when considering changing the providing sector of a good, it is not always clear how the alternative will unfold. Wolpert concludes that expansion of governmental function in the service area contains both crowding out and

crowding in effects on private donations. Most empirical evidences suggest a modest dominance of crowding out effects, although dominating crowding in effects are commonly found in certain charitable industries. According to Steinberg (2003), Brooks finds that the crowding in effects dominate for small government contribution, whereas the crowding out effects come to dominate for modest and more extensive public financing. Elsewise, I refer to Steinberg (2003) for a very fruitful and interesting discussion on recommended public policies towards nonprofits, emphasizing taxation, competition policy and much more.

### **7.1.3 Fees**

A widespread belief is that nonprofit are primarily financed through private charitable donations. However, The Johns Hopkins Comparative Nonprofit Project from 1995 showed that private fees and sales in Japan, the United States and four European countries accounted for nearly fifty percent of the total financing in nonprofits with an element of voluntary contributions (Anheier 2003).<sup>46</sup> Member fees will obviously play an important role in clubs and consumer owned cooperatives. According to Steinberg (2003), Zhang finds in his master thesis that a rise in the tuition fees at research universities increases the level of donations. Weisbrod (1998) describes user-fees a ‘two-edged’ sword, in the sense that the target group could be crowded out, when the good in question is financed through user-fees. He suggests price discrimination, where target groups with low solvency are offered lower prices, as a solution to the crowding out problems.

### **7.1.4 Sales**

Sales constitute the vital source of finance for nonprofit firms in the business sector. It can also be a sustainable source of financing for many other types of nonprofits, including voluntarily based charities. According to Steinberg (2003), Kingma conducts a rare adaption of portfolio theory, highlighting the covariances between nonprofits’ sources of incomes. In his empirical studies, Kingma shows that commercial activities could suppress donations. Steinberg points out that prices and quality of goods could have a direct impact on donors in non-donative industries and calls for more empirical research on this topic. Weisbrod (1998)

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<sup>46</sup> In addition to Japan and United States, The Johns Hopkins Comparative Nonprofit Project’s investigation in this instance covered the European countries France, Germany, Hungary and United Kingdom.

highlights how nonprofits tend to engage in commercial partnership and sponsorship contracts with private firms, when the income from private and public donations are low compared to the operative ambitions. An increase in commercial activities could dampen the effect of a donative withdrawal. In the context of commercial partnerships, Weisbrod mentions nonprofits' research alliances with private firms, inter alia in the American University sector.

## **7.2 Corporate Financial Rigidity and Flexibility**

This subchapter I devote to the financial rigidity challenges of nonprofits; a field with very limited literature. Putting interior information problems aside, there are still other challenges related to the austerity and expansion of nonprofits due to financial rigidity. This is particularly the case in business foundations. Growing empirical evidence supports the notion that the nonprofits activities are very little redistributive. For instance, Wolpert (2003) finds that there was very limited distribution of nonprofits' revenues across suburban and city boundaries.

By the same token, Bielefeld, Murdoch and Waddell find that nonprofits are mostly influenced by their local environment (Bielefeld and Galaskiewicz 2003). I am rather surprised that the field of corporate financial rigidity has not been explored more. Perhaps there are not that many economists, who have both nonprofits and corporate finance as fields of research. I am not the only one calling for more research on this matter; Steinberg describes the study of nonprofit mergers, acquisition and divestures as 'one of the least explored realms of nonprofit behavior' (Steinberg 2003, page 294). Yet, a breakthrough could be near. Both Bowmann and Jegers made interesting contributions to the topic as late as 2011. I will address the financial rigidity challenge in section 7.2.1, before I discuss some possible imperfect solutions to the problem in section 7.2.2.

### **7.2.1 The Financial Rigidity Problem of Nonprofits**

Financial rigidity provides a challenge for nonprofits' evolution. Brody (1996) pins out that nonprofits must either reinvest or spend, due to their disability to distribute profits. Cooperative and mutual companies could face some of the same financial rigidity issues as business foundations. Yet, it is reasonable to believe that their interaction with their customers will make them more financially flexible, at least while restricting the scale of their

operations. Steinberg (2003) underlines that nonprofit cannot sell meaningful shares of stock to secure financial capital, since they are unable to distribute dividends. He sees that an implication of this rigidity is that nonprofits in general are unable to choose the combination of debt and equity that minimize the cost of capital. The inefficient debt ratio will in turn impede the growth rate of the nonprofit sector. Geller et al. (2010) find that capital limitations make it more difficult for American nonprofits to pursue their innovative spirit and their urge for innovations.

Hansmann (1996) suggests that nonprofits occur, when the cost of ownership or contracting is too high. In this regard, Bacchiega and Borzaga (2003) claim that a usually neglected information failure is the one occurring in relation with production of social services, deriving from ownership costs. They argue that limitation on the distribution of profits derives from an institutional choice, rather than an exogenous imposition (ibid.). Ownership change is however another limitation for nonprofits, particularly in absence of a holding company. In this context, Hansmann and Thomsen (2009) pin out that the foundation's governance could avoid public listing with the foundation as a partial owner of the new company, in fear of being replaced. If present, such fear would obviously enhance the financial rigidity issues. Furthermore, Brody (2003) points out that the 'hostile take-over mechanism' is not available for nonprofit organizations as a disciplining threat, in absence of privately held stocks.

By emission and dividends, the corporation's return on equity, adjusted for the risk level, are expected to be equal the market return on equity in the long run. A foundation does not have the same financial flexibility, which could give it a competitive disadvantage. If on the one hand, a corporation is run optimally given its equity level, and the corporation's return on equity is lower than required in the market for a given risk level, it can sell its least productive assets and give out dividends. If on the other hand, the corporation's return on equity is above the market requirement, it can finance its unrealized beneficial projects by running an emission or by equity injections from the owners.

In a competitive market with full information, nonprofits' financial rigidity does not have to imply a significant social loss from a social planner's point of view. If the nonprofit is unable to make use of a profitable business opportunity, some other firm will realize this and take advantage of the arbitrage opportunity. If the foundation is unable to get rid of unproductive equity capital, it will loose it in time. In the process, other firms could be affected negatively

by an overinvestment in the industry in question. However, if the foundation possesses some sort of competitive advantages like for instance economic of scale and scoop or possibly peculiar assets and competence, the financial rigidity of foundations could become a lasting social problem as well.

In a recent study, Bowmann (2011) models the financial side of non-donative nonprofits. He divides the nonprofits' financial issues into capacity and sustainability in the short run and the long run. In the short term, resiliency is the key feature, whereas maintaining services is the core characteristic in the long term. An organization's financial capacity will be sustainable over time, if it manages to maintain its assets at their replacement costs. In order to achieve sustainability, managers must be given short term budget surplus targets to prevent economic shocks that could force liquidation upon the concerned nonprofit. Applying his model on empirical data from the United States, Bowmann finds that nonprofits are more attentive towards short term generation of unrestricted cash than long term capital preservation.

Another recent study was made by Jegers (2011), who has developed the first nonprofit corporate finance model in order to achieve a better understanding of nonprofits' financial constraints and their interaction with the agency problems present. For nonprofits, the difficulties in ensuring new equity constitute an additional capital restraint, which are independent of the organization's creditworthiness. According to Jegers, financial restraints are expected to emerge, when either the admissions to increasing revenues are slim, or the nonprofit management is unwilling to exert high fundraising efforts. He finds that the debt level decreases with the severity of the agency problems. Moreover, Bowmann and Jegers both analyze the limitations of financial expansions, but neither of them emphasis the possibility of desirable austerity. I find Bowmann and Jegers' recent contributions to the literature both interesting and encouraging, and I look forward to follow future developments in this part of the nonprofit literature.

As discussed elsewhere in my thesis, there could be many situations, where foundations may succeed better than corporations, implying that they also could be desirable from a social point of view. Yet, the point of financial rigidity will by itself constitute a partial argument against nonprofit as an institutional form in the business life. Although financial inflexible foundations obviously could loose profits and other firms are affected in the process, the social losses are usually only temporary. The losses will necessarily depend on the equity

return gap between the nonprofit and the market, as well as the forprofits ability to adjust their production levels in terms of direct costs and time-consumption. Nevertheless, one may argue that the financial rigidity of nonprofits is only partial. In the following, I will discuss how foundations can adjust their size and equity holding. Salamon (2003) highpoints that the voluntary sector role is confined by the limited access to resources. He labels this property as the insufficiency failure. (I refer to subchapter 5.1 about voluntary failure theory for more on this discussion).

### **7.2.2 The Financial Adjustment Mechanisms of Nonprofits**

One possible way to expand foundations' activities is to create a holding company and run an emission. Most likely, the foundation would claim a certain minimum owner share and some constituted control rights in order to secure sufficient control to pursue its aims. An example is in this regard is the Carlsberg Foundation, which by its founding document must hold at least 51 percent of the votes in the Carlsberg Group and more than 25 percent of the share capital (Carlsberg Group 2011a). By the same token, the Norwegian insurance foundation GjensidigeStiftelsen (2012) privatized its insurance company in 2010, inviting other investors into the business. Hansmann and Thomsen (2009) suggest that well-performing foundations may find it easier to list their shares and could be more inclined to do so, due to more profitable growth prospects. Furthermore, they believe higher profits could be used to buy other companies. Another possibility for exploiting unrealized profit opportunities could be to hire external consultants. In order to be a relevant alternative, the costs of hiring some external associates must be less than the cost of finical rigidity and recruiting them internally.

In addition, fund-raising could be a solution, if the foundation has sufficient back-up in the society. Most empirical studies indicate that fundraising have significant positive financial return. Goodspeed and Kenyon argue that donations and tax exemption could lead to lower costs of capital for the nonprofit sector (Steinberg 2003), but even so, it remains questionable whether these nonprofits become self-sustainable without tax advantages over forprofit firms or not. Chang and Tuckman find empirical evidence for large charities having vast accumulated surpluses in the end of the year. The surpluses were used both in operations and for organizational development purposes, without shirking on quality. This could be taken as an indication of partial profit-maximization in nonprofits with additional concerns (Bielefeld and Galaskiewicz 2003).

In the case where financial austerity is desirable, taking an equity return perspective, dividends from a holding company could be a solution. Thereafter, the foundation could possibly use its own dividends to buy a larger share in the holding company. Another possibility could be to engage the foundation in another industry with a higher rate of return, given that this alternative industry's projects were not evaluated initially. After the global financial crisis hit in 2008, the required rates of return for nonprofits have generally increased (Anheier 2009). Nonetheless, entry and establishment in another industry may require substantial investments and could also violate the foundation testament. One could also imagine a scenario where the foundation could invest the superfluous capital in an investment fund. Moreover, both financial and real capital investments could give nonprofits advantages in the long run.

Many business foundations have a charity back-up that could be utilized to decrease their activities, when their business prospects are slim. Many business foundations are engaged in charity purposes. Common goods and other social beneficial projects provided through charity are often underprovided. Using the unproductive capital to support such projects could be desirable from the foundation's perspective, if it evaluates a charity project's social value as larger than its private value. If conversely, the foundation is acting in an environment dominated by business cycles, where the unproductiveness of the capital is only temporarily, charity might be a poor solution. Moreover, the capability to deal with financial rigidity through charity or other measures may be limited by the foundation testament. Different sorts of foundation testaments seem likely to call for different kinds of actions to deal with financial issues. At last, bankruptcy and liquidation will be similar for nonprofits and forprofits, except for that there are no 'real' owners, who loose their equity holdings in nonprofits. A nonprofit operational exit usually implies a specified donation in compliance with the nonprofit's statutes.

## 8 Conclusion

In my master thesis in economics, I have investigated a variety of features related to nonprofit organizations with special emphasis on the ones operating in the business sector. The main question I raised was: ‘What are the pros and cons of nonprofits, and in what ways do they differ from other organizations?’ Although a large and ambitious project, I will sketch some answers to this question here in my conclusion.

I start by investigating one of my probed further: ‘What are the roles of the nonprofit sector, and why does it play these roles?’ Throughout my thesis, we have seen that the third sector constitutes a highly heterogeneous gathering of organizations. Nonprofits are particularly important players in sectors of culture, health, knowledge and social services. Up to the global financial crisis in 2008, the sector grew worldwide. In general, different parts of the nonprofit sector become relevant, when they achieve some kind of comparative advantage contra forprofits and public firms. Nonprofits generally differ from forprofits, because they do not maximize profit. The lack of profit incentives may not alter sufficient conditions for efficient behavior. Yet, it could give nonprofits a comparative advantage contra the forprofit sector in instances, where profit motivation is detrimental. Compared to public firms, nonprofits have different information, and their financing is more vulnerable. Conversely, nonprofits are less bound by political considerations and their provision of political sensitive goods is generally less controversial. Moreover, nonprofits can serve demand that do not comply with the public consensus. In addition, the bureaucracy is smaller, which may make them easier to manage.

One of the important roles of the nonprofit sector is related to Hansmann’s path-breaking trust approach, which he originally formulated in a paper published in 1980. The approach sheds light on how nonprofits can appear more trustworthy in the provision of unverifiable services than forprofits, due to their lack of profit incentives. Let us imagine that you were unfortunate and injured one of my hips, after falling on the ice. Then, you might be reluctant to check into a forprofit hospital, fearing that the personnel will shirk on the quality of their services with the purpose of earning more money. Similarly, you might be afraid to place your young darlings in a forprofit children care, fearing that the care center will allow more children than they can handle, in order to earn profit. By the same token, you may hesitate to send your elderly parents to a forprofit nursing home, where the size of staff could be relatively small.



In such cases, one may be more confident about the quality of the services, if the supplier is a nonprofit. This is because the nonprofit hospital aims to provide best possible quality or sufficient quantity of the good in question, rather than seeking to earn profits. Yet, if you are a poor student like me, you might be willing to accept a lower quality at a forprofit hospital in case of a broken hip, given that lower quality makes the price sufficiently lower. Such price-quality wedges are frequently observed in real-life. Nonprofit hospitals could also serve high-quality demand, not saturated by public hospitals. In addition to the traditional applications, I believe that trust theory could be combined with green consumer theory. If you buy a 'fair trade product' from profit-motivated firm to support less fortunate workers, you might be skeptical to whether the extra payment reaches its intended recipient. I claim that a nonprofit status or certification may signal more reliable social corporate responsibility in this regard.

My second probed further was: 'What do nonprofits do when they are not maximizing profit, and which other aims are relevant?' We have seen throughout my thesis that this is a complex matter. A rough answer would be that nonprofits aim to fulfill the objectives of its current stakeholders, founders and donors, which could contain both altruistic and egoistic features. When reviewing the theoretical approaches, we have remarked how nonprofits' various aims can serve different needs. A lesson from the entrepreneurship approach is that altruistic and egoistic goals are decisive for the extent and nature of nonprofit entrepreneurship. By the same token, a learning outcome from the stakeholder approach is that nonprofits could be a leeway for various stakeholders to secure their interest. Besides, the organizational behavioral approach shows us how nonprofits' priorities and tactics can be the best response to various dynamics in the surroundings. Thus, forprofits' and nonprofits' behavior may either converge or self-select to different niches, when both institutional forms survive in the competition.

Another influential rationale for nonprofits stems from the public good approach, originally formulated by Weisbrod's pioneering work from 1975. The approach highlights how nonprofits can provide economically beneficial public and quasi-public goods, which both the private and public sector fail to provide. Take for instance the university sector. Let us consider education as a private good and research as a public good, with positive spillover effects on the future education and research. Possibly, the nonprofit universities prioritize research more than forprofit universities, both because they care more about the research, and because the private universities do not take the long synergy effects into consideration. This could explain the nonprofit dominance among the top universities in the United States.

Suppose on the other hand that an art gallery is unprofitable for forprofits and that the governing politicians do not want the public sector to finance it. Still, there may well exist sufficiently demand for the related goods and services in the market. In that case, a nonprofit may be able to operate the art gallery through cross-subsidizing sales and donations, driven by altruistic motives, a social glow or social pressure. Here, it is important for the gallery to take potential crowding in and crowding out effects on donations into account, when choosing the scale of fees and sales. In my thesis, I show formally how both the mathematical signs of management's valuation of the private good and crowding effects influences on the nonprofit adaption. The voluntary failure approach turns the problem upside down, embracing the nonprofit sector as the premier provider of public goods, and arguing that the public sector's role is to be a supplement. From the view of the government, crowding in and crowding out effects should be taken into consideration, when choosing the level of public support.

Another question I raised was: 'How does the interior incentive structure function when the organization has other aims than profits, and there are no owners to discipline the management?' In real-life we observe both well-functioning and dysfunctional nonprofits. The fundamental problem, especially for entrepreneurial nonprofits, is the lack of owners that could discipline the management, and thereby prevent moral hazard. Idealistic managers may self-select to the nonprofit sector, but nonprofits also run a danger of being evaded by rent-seekers. Yet, governing failures could be counteracted by various implicit and explicit control mechanisms of both non-behavioral and behavioral characteristics. I advocate that motivation and common aims may play an important role in limiting the interior irregularities. More concrete, I argue that nonprofits may have an ability to attract green workers, which are willingly to accept a lower salary for work they perceive as more meaningful. I have showed how this feature can be formally integrated into nonprofit modeling.

Through my own Game of Internal Control, I have also illustrated how non-behavioral control structures may or may not facilitate efficient behavior. In the game, three teams constitute a control circle. Each team could choose to induce effort and inspect, or to shirk and not inspect. The game is a Pareto coordination game, where everybody either induces effort to the common good or shirks in the Nash equilibriums. Individuals are likely to have more impact on the organizational outcomes in small nonprofits, making them more vulnerable than larger nonprofits. In large nonprofits the Pareto optimal Nash equilibrium is typically prevailing, since they have been able to grow large, and single individuals have less influence.

Another challenge for nonprofits in the business sector is the lack of financial flexibility, and how the related austerity and expansion problems could be overcome. Financial inflexibility is one of the most neglected realms in the prevailing economic literature about the nonprofit sector. I have therefore given the topic much attention in my thesis. The absence of tools to implement an optimal debt rate through dividends and emission obviously constitute a limitation for nonprofits growth. Yet, there exist some mechanisms to partially encounter these issues, including charity, consultant services, establishment of holding companies and investment funds and fund raising. However, the use of these is often limited by the foundation document. If a nonprofit has some sort of comparative advantage, such that other firms can not make use of their beneficial business opportunities, the rigidity challenge does not only constitute a loss for the nonprofit in question, but also for the society at large.

I conclude that nonprofits could be the best response to certain governing and market failures, both on the demand side and supply side of the economy. Moreover, nonprofits may achieve comparative advantages contra forprofits and public firms under certain circumstances, by their combination of inability to distribute profits, political autonomy and social aims; and for some nonprofit organizational designs; their leeway for stakeholder control. In my opinion, both green consumer theory and green worker theory could have a role to play in the future development of nonprofit theory. I argue that the nonprofit approaches should be viewed as complementary, rather than mutually exclusive. Despite of the diverse nature of nonprofits, I believe it is possible to integrate the approaches further. The stakeholder approach makes a leap in this direction, but the theory still has to overcome its inconsistency with regard to the validity of internal and external contracting. Yet, it may also be an advantage to have a wide range of approaches, throwing lights on different characteristics of nonprofits.

Until recently, a major shortcoming of the nonprofit literature was the absence of a corporate finance theory for non-donative nonprofits, but now new and exciting literature is emerging. For future research, I hope see a further success in formalizing the theory, making it easier to conduct empirical investigation in line with the approaches. More generally, I encourage future microeconomic researchers to continue the institutional mapping of not only nonprofit organizations, but also forprofit and public organizations. Lastly, I would like to stress the need for formal integration of motivational factors and alternative behavioral conducts in the principal-agent models. Integration of behavioral features in contract theory would be a major break-through, with relevant appliances in the study of nonprofit.

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# Attachments

The two articles, ‘We Do. Do You?’ from 2007 and “The Process” from 2011, both written by Lindøe, are here rendered as attachments as attachment A and attachment B, respectively. Both articles reflect Det Norske Veritas’ (DNV) environmental concern and use of fringe goods. They are obtained from Det Norske Veritas’ (DNV) intranet, DNV Inside.

## A. WE do. Do you?

**Through DNV’s new environmental project, WE do, DNV will grant initially up to NOK 20 million in 2008 to help employees around the world limit their personal environmental footprint.**

“WE do is designed to help people working in DNV limit their personal environmental footprint – which is estimated to be larger or at least comparable to the footprint from DNV’s operations. To achieve this, DNV initially has put aside initially NOK 20 million in 2008 to partially finance personal environmental measures initiated by DNV employees,” says CEO Henrik O. Madsen.

### **YOU Duggest Ideas**

“The list of measures that will receive financial support under WE do has not been decided yet because we want to get your input on which measures we should fund,” says Henrik O. Madsen. “I therefore encourage all employees to post their ideas at the WE do suggestion site before 17 January. A selection will then be chosen for the catalogue of measures that employees can apply for.”

Suggestions from employees will be gathered until mid-January. The first 20 employees who post suggestions that are included in the catalogue will receive a Voltaic solar panel backpack made from recycled PET.

The final catalogue of applicable measures will be presented by early February, when the application process will start. The application deadline is March 2008. WE do will finance up

to 2/3 of the cost of the measures in the catalogue, with the maximum grant amount per employee limited to NOK 10,000.

## **Fulfilling Our Vision**

“Not only through our operations and services, but also in our daily life, must we work towards fulfilling DNV’s vision of Global impact for a safe and sustainable future. That is why we are launching WE do,” Henrik O. Madsen concludes.

*Date: 2007-12-12*

*Owner: Kristian Lindøe*

*Controlling Manager: Katrine Sundbye*

## **B. The Process**

WE do is now closed for the 2011 year. Information about WE do for 2012 will be published when it is available, so please keep an eye on this page and the news channels!

Please note that (as always) there have been changes from previous years. We kindly request that you carefully review the text as well as the updated rules & regulations before applying.

As with last year, once you click the "I do" button, you will not be permitted to change your application... so choose wisely!

### **Background**

If you are a Class A (permanent) employee you are entitled to apply for 2/3 the cost of a project you select from the WE do project list, up to the equivalent of 10,000 NOK (before taxes) in your local currency.

The amount you receive is considered additional salary and therefore subject to local tax regulations. For example, if you are subject to a 20% tax rate and are eligible for NOK 10,000 from WE do, you will receive a net amount of NOK 8,000.

## **Some Changes from Last Year**

Although individual funding allowances remain the same, total funding for WE do is NOK 30 million this year. You may also notice that the 2011 Project list is shorter than previous years. Priority has been given to higher impact projects, both in terms of reducing environmental footprints and in changing habits. Project applicability is now organised by country (as opposed to region) and you can find out which projects are applicable in your country here.

## **How to Apply**

It is important to note that the final date for applying for WE do is 15 October (after which, the application will be closed) so long as there is still funding available and all documentation must be signed and submitted to payroll in your country by 1 November. These dates are firm, so please make sure you're on time!

So are you ready to get involved? Here's how you do it...

### **Step One:**

Read the Rules and regulations.

### **Step Two:**

Consult the Project list and the Country list to find out which projects are available for you to apply for.

### **Step Three:**

Read all the information on this page before going to the application page. Select your country, the project you will apply for, and your currency (please note: you do not get to choose which currency you would prefer to be paid out in, you must select the currency of your country.) Fill in the total amount your project will come to (if you are not certain of the total cost of your project, estimate the maximum it could be. You will not be permitted to change this amount later and final payout will be 2/3 the amount of your receipts up to the amount you originally applied for.) Review all information and check the box stating you

have read everything before clicking “I do” to confirm. You will NOT be permitted to change your project after you have clicked “I do” so if you have questions, you must ask before applying...or remain forever silent. ☺

If you are applying for the cycling to work project, you still need to apply for WE do as outlined above, in addition to filling out the WE do cycle calendar.

#### **Step Four:**

After you have applied, you will receive a confirmation email. Keep this email, as you will need to submit it to payroll. Print out the Expense statement. When you have purchased/completed your project, you must fill out the expense statement, have it signed by your line manager and then submit it along with the confirmation email, all receipts and the manufacturer specifications (if required) to payroll in your country (in Norway, please send the documentation to NSHNO 075.) Please note: it may take a few weeks for the payment to be processed, so please be patient! After you have submitted all documentation, if you have questions about the status of the payment, please contact your local payroll, as payout is handled locally.

#### **Follow-Up**

Although there are no official obligations after receiving the money, DNV asks that you continue to monitor your environmental footprint to ensure a positive long term effect. If you are interested in learning more about the environmental effect of each project, you can click on the footprint calculator on the application page. The footprint calculator is still available even after you have applied.

Questions? Many of them can be answered right here on this page! (Try the Frequently Asked Questions, for example.) If, after a long and harrowing search, you still can't find the answer, please send your questions to either WEdo@dnv.com or, if you live in Greater China, WEdoChina@dnv.com. Note: when emailing, please include your employee number.

*Date: 2011-16-12*

*Owner: Kristian Lindøe*

*Controlling Manager: Katrine Sundbye*